Supreme Court, U. S.
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IN THE

# Supreme Court of the United States

October Term, 1978

No. 78-746

EVA GROSSMANN,

*Petitioner,*

vs.

EDWARD S. REDINGTON, Trustee, and SECURITIES INVESTOR PROTECTION CORPORATION,

*Respondents.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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The petitioner Eva Grossmann respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding on June 12, 1978.

## OPINIONS BELOW

The opinion of the Court of Appeals, not yet reported, appears in the Appendix hereto* at pages A1-A16. The opinion of the District Court is reported at 425 F. Supp. 212 and appears in the Appendix hereto at pages A19-A32. The opinion of the Bankruptcy Judge is unreported and appears in the Appendix hereto at pages A33-A40.

## JURISDICTION

The Judgment of the Court of Appeals for the Second Circuit was entered on June 12, 1978. A timely petition for rehearing *en banc* was denied on August 7, 1978 (A17-A18), and this petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

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*The Appendix is bound in a separate volume.



## QUESTIONS PRESENTED

1. May the Securities Investor Protection Act, which is an integral part of the comprehensive securities regulation system enacted by Congress for the purpose of protecting investors, be interpreted in such a manner as to harm innocent defrauded investors in contravention of congressional policy and decisions of this Court?

2. May the illegal actions of a securities broker and the New York Stock Exchange's wrongful approval of a sale of securities which is plainly prohibited by an applicable securities regulation, divest an innocent unsophisticated investor of the insurance which Congress has established for the purpose of protecting investors?

3. May the securities regulatory system which Congress created for the purpose of protecting investors, profit from its own wrongful conduct at the expense of an innocent unsophisticated investor?

4. When a stock exchange issues rules and regulations pursuant to statutory requirements, may a court selectively and discriminatorily enforce one of the exchange's rules, but refuse enforcement of another equally important exchange rule, designed to protect a financially unsophisticated investor, which has been breached by the exchange itself to the detriment of such an investor?

5. May innocent unsophisticated investors who have been defrauded by an unscrupulous securities broker be deprived of their common law and state statutory remedies by a rigid and restrictive interpretation of the Securities Investor Protection Act?

## STATUTORY PROVISIONS AND REGULATIONS INVOLVED*

15 U.S.C. § 77p

15 U.S.C. § 77r

15 U.S.C. § 78f

15 U.S.C. § 78bbb

15 U.S.C. § 78ccc

15 U.S.C. § 78ddd

15 U.S.C. § 78fff

15 U.S.C. § 78iii

New York Stock Exchange Rule 325

New York Stock Exchange Rule 325.20

New York Stock Exchange Rule 405

Illinois Revised Statutes, ch. 121½ § 137.12

Illinois Revised Statutes, ch. 121½ § 262

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* These statutory provisions and regulations are set forth in the separately bound Appendix to this petition.



## STATEMENT OF THE CASE

William J. Scott, Attorney General of the State of Illinois, files the present petition on behalf of petitioner, Mrs. Eva Grossmann, an Illinois citizen and resident who has been defrauded by an unscrupulous securities broker. He files this petition because the issues raised herein are of grave concern to all the citizens of the State of Illinois and to the entire nation.

Petitioner, a native of Romania, immigrated to the United States with her husband in 1950 (A 72). She found a job as a fitter in a Chicago department store where she is still employed. In 1967, shortly after the death of petitioner's husband, a Mrs. Meiselman, one of the store's customers who was aware of petitioner's circumstances, told petitioner to consult her husband, Mr. Leo Meiselman, executive vice-president of Weis, Voisin, Cannon, Inc., in Chicago. Mrs. Meiselman told petitioner that Mr. Meiselman had successfully invested funds for several widows and would help and advise her in investing her money (A 73). Petitioner thereupon consulted Mr. Meiselman and, at his direction, turned over first her entire life savings of $15,000 to Weis, Voisin, Cannon, Inc., and later $5,000 which petitioner had received from a life insurance policy on her husband's death (A 73).

In return for the $15,000 she received a letter from the broker acknowledging receipt of this amount; the letter stated that the funds were "to be used to purchase two-year debentures . . ." (A 66). Nothing was mentioned about any "subordinate" debenture. Around that time petitioner received a certificate entitled "WEIS, VOISIN, CANNON, INC. TWO YEAR DEBENTURE BOND" for $15,000. Nothing in the caption indicated that the debenture was

subordinate. Only in the second paragraph of the document was there a mention made, IN FINE PRINT, of a subordination clause (A 67). Mr. Meiselman never explained or even mentioned a subordination clause (A 63, A 73) and even if petitioner had read the fine print she would not have comprehended its significance (A 73). Petitioner was completely naive and uneducated in financial matters and relied solely upon the advice and direction of Mr. Meiselman (A 73). All papers signed by petitioner, including the application to the New York Stock Exchange for approval of subordinate status (which petitioner did not understand but thought related to proof of citizenship), were signed by her solely, and in complete reliance on Mr. Meiselman's advice and pursuant to his direction (A73-A 74).

As to the $5,000 she never received a debenture certificate but merely a receipt acknowledging her check in the amount of $5,000 "for Debenture Account of Customer" with no mention, even in fine print, of a subordination clause (A 68).

The debentures were automatically renewed by the brokerage firm (A 63). Weis, Voisin, Cannon, Inc., was subsequently sold to or taken over by a different corporate entity, Weis Securities, Inc., the present bankrupt; however, petitioner never received any notification of the takeover and for the first time learned of it through a letter sent to her by Weis Securities, dated April 27, 1973, informing her that the firm's auditors were making an examination of the firm's financial statements and that she should confirm her subordinate debenture account in the amount of $20,000. Shortly thereafter, liquidation proceedings were commenced against Weis Securities, and she read in a newspaper of the firm's bankruptcy (A 75). The liquidation proceedings against Weis Securities were instituted



by the Securities Investor Protection Corporation in May, 1973, under the Securities Investor Protection Act of 1970.

The Trustee has taken the position in the liquidation proceedings that all so-called subordinate debenture holders, including petitioner, must be treated alike, regardless of any fraud practiced upon them, and that they are estopped from rescinding their subordinated loan agreements embodied in the debentures. In pursuance of that theory, he moved for a summary judgment which was denied by the Bankruptcy Judge because of the existence of material questions of fact (A 40).

The District Court reversed the Bankruptcy Judge and the Circuit Court affirmed the District Court. Petitioner was treated by the District Court and the Court of Appeals as if she had been a sophisticated investor, equating her status with that of the other subordinate debenture holders involved in the present liquidation proceedings, who, unlike petitioner, were large investors well versed in financial matters.

## REASONS FOR GRANTING THE WRIT

### I.

### THE LOWER COURTS' SUMMARY DENIAL OF PETITIONER'S CLAIM CONTRAVENES THE POLICIES WHICH CONGRESS HAS DECLARED VITAL TO THE NATION'S ECONOMY.

The importance of the instant case involving the liquidation of a bankrupt brokerage firm far transcends the claim of petitioner. It is a case of first impression and raises issues of grave national concern which should be decided by this Court because they affect directly the nation's economy. The lower Courts' refusal to grant petitioner the protection which Congress, under the Securities Investor Protection Act (hereinafter SIPA),[1] intended to afford investors of brokerage firms in liquidation, is destructive of the public confidence in the securities markets which both this Court and Congress have recognized essential to the economic health of our nation. *Securities and Exchange Comm.* v. *Capital Gains Research Bureau,* 375 U.S. 180, 201, 11 L. Ed. 2d 237, 252 (1963); House Report No. 91-1613; 91st Cong. 2d Sess. (1970), 3 U.S. Code Cong. & Adm. News 5254, 5255 (1970).[2]

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1. 15 U.S.C. § 78 aaa *et seq.*

2. The House Bill was passed in lieu of the Senate version.



### A.

### History And Purpose Of Securities Regulations

The Securities Act of 1933[3] and the Securities and Exchange Act of 1934[4] were designed to eliminate certain abuses in the securities industry which had contributed to the stock market crash of 1929 and the depression of the 1930's. *Securities and Exchange Comm.* v. *Capital Gains Research Bureau, supra* at 375 U.S. 186. "The primary purpose of the 1934 Exchange Act was to protect customers of the stock exchanges—that is public investors." *Lank* v. *New York Stock Exchange,* 548 F. 2d 61 (2d Cir. 1977). The method used was to impose a statutory duty upon the exchanges to protect investors by regulating the exchanges' members, with the federal government (through the SEC)[5] retaining the power to step in only when an exchange failed to regulate its members in a manner that adequately provided protection to investors. *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 352, 10 L. Ed. 2d 389, 397, *reh den* 375 U.S. 870, 11 L. Ed. 2d 99 (1963).

Subsequently, Congress enacted the Securities Investor Protection Act of 1970 (SIPA) for the primary purpose of providing "protection for investors if the broker-dealer with whom they are doing business encounters financial troubles." House Report No. 91-1613, 91st Cong. 2d Sess. (1970), 3 U.S. Code Cong. & Adm. News 5254, 5255 (1970).

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3. 15 U.S.C. § 77a *et seq.*

Securities Acts citations are to the Acts as they existed prior to the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (June 4, 1975). The essential regulatory scheme remains the same today.

4. 15 U.S.C. § 78 a *et seq.*

5. Securities and Exchange Commission.

This House Report discloses that the principal reasons why SIPA was needed and enacted were as follows: 1) while the rules and regulations enforced under the 1934 Exchange Act provided "important protection for investors, it is clear that these rules are not sufficient by themselves to prevent the exposure of customers to substantial risk of loss as a result of financial mismanagement by a firm or its employees or insolvency." *Id.* at 5256; and 2) the financial failure of a substantial number of brokerage houses resulted in the loss of investors' funds with a corresponding weakening of confidence in the U.S. securities markets, and such lessened confidence has an adverse effect on the entire economy. *Id.* at 5255.

SIPA provides additional protection to investors and retains all of the safeguards for investors which existed at the time of its enactment. Section 2 of SIPA[6] expressly provides that the 1934 Securities Exchange Act shall apply as if SIPA "constituted an amendment to, and was included as a section of such Act."

Section 3 of SIPA[7] creates the Securities Investor Protection Corporation (hereinafter SIPC). In a liquidation proceeding of a brokerage firm, SIPC is supposed to pay, within its statutory limits, the amount of customers' losses from a fund which SIPC collects from all securities dealers registered under the 1934 Securities Exchange Act (much in the way that the Federal Deposit Insurance Corporation protects depositors of banks). *Securities and Exchange Comm.* v. *F. O. Baroff Co., Inc.*, 497 F. 2d 280, 281 (2d Cir. 1974); House Report No. 91-1613, *supra* at 5255.

For the reasons set forth below, the lower courts' refusal to afford petitioner the status of "customer" under

6. 15 U.S.C. § 78 bbb
7. 15 U.S.C. § 78 ccc



SIPA violates the intent of Congress; renders the protection which Congress created illusory and meaningless; allows the system which has a statutory duty to protect investors to profit from its wrongful acts at the expense of innocent investors; and weakens confidence in U.S. securities markets with the inevitable adverse effect on the national economy.

**B.**

**The Securities Investor Protection Act Must Be Construed In A Manner Which Will Provide Meaningful Protection To Investors.**

Petitioner, a fitter in a Chicago department store, a Romanian immigrant completely unsophisticated and uneducated in financial matters, was told by one of the store's customers who was aware of the recent death of petitioner's husband, to contact Mr. Leo Meiselman, executive vice president of the brokerage firm of Weis, Voisin, Cannon, Inc. The customer, who was the wife of Mr. Meiselman, told petitioner that her husband had successfully invested funds for several widows. Petitioner then consulted Mr. Meiselman, and being completely ignorant in investment matters, relied totally upon his expertise and advice. At Mr. Meiselman's direction she turned over $20,000.00 to his brokerage firm. This sum consisted of her entire life savings of $15,000.00 plus $5,000.00 life insurance proceeds which she had received upon the death of her husband.

Weis, Voisin, Cannon, Inc., was a member of the New York Stock Exchange (hereinafter NYSE), and Mr. Meiselman, in blatant violation of NYSE Rule 405,[8] invested petitioner's entire life savings in subordinate debentures of his

8. SEC Rule 15 b 10-3 is a comparable rule which applies to broker dealers who are not members of an exchange.

own brokerage firm. NYSE Rule 405, often referred to as the "suitability" or "know your customer" rule is supposed to prevent brokers from inducing unsophisticated small investors to invest a large portion of their total assets in investments which are speculative and/or not adequately secured. It is an integral part of SEC regulation. *Starkman* v. *Seroussi,* 377 F. Supp. 518, 524 (S.D.N.Y. 1974).

In *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith Inc.,* 410 F. 2d 135 (7th Cir. 1969), *cert. denied* 396 U.S. 838 (1969), the Court held that the purpose of NYSE Rule 405 was to protect the public and a violation of it by a member broker was actionable, constituting a violation of Section 6 of the Securities Exchange Act of 1934.[9] The SEC expressed concern over the very type of transaction by which petitioner was defrauded in the present case. In Securities Act Release No. 5215, Exchange Act Release No. 9412 [1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78, 455 (Dec. 9, 1971), referring to the efforts of some broker-dealers to persuade prospective customers "to subordinate their securities accounts to the claims of other customers and the general creditors of such broker-dealers", the SEC cautioned that such solicitations "may also result in violation of the anti-fraud provisions of the Securities Act and the Exchange Act, and of the regulations thereunder."

Although section 6 of the Exchange Act placed a duty upon the NYSE to enforce Rule 405 against Weis, Voisin, Cannon, Inc., the NYSE, rather than enforcing the rule, participated in its violation. It approved a subordinate debenture application for a total sum of $20,000, in which a widow working as a fitter for her livelihood, upon the broker's prodding, had stated in her application that her total financial worth was $30,000, which included her furniture, etc. The NYSE thereby acted in crass contravention of its responsibilities by wrongfully approving the sale of subordinate debentures to petitioner so that petitioner's money could be used by the firm to help it meet net capital requirements (NYSE Rule 325). NYSE Rule 325.20 provides, among other things, that subordinate debentures constitute unencumbered capital assets, enabling the broker to continue to deal with the public.

9. 15 U.S.C. § 78 f.



The lower courts discreetly ignored the violation of the suitability rule (NYSE Rule 405) and based their decisions exclusively on the net capital requirements rule. It is respectfully submitted that such arbitrary selective enforcement of rules is highly improper. This is particularly true in the instant case because the net capital rule finds no application to an investor's funds which have not been lawfully subordinated. Since the sale of subordinate debentures to petitioner was plainly prohibited by NYSE Rule 405, it could not alter petitioner's legal status, and because petitioner never occupied the legal status of a subordinate lender, the net capital rule has no application to her claim.

The term "customer" as used in SIPA is synonymous with that of investor. *Securities and Exchange Comm.* v. *F. O. Baroff Co., Inc.,* 497 F. 2d 280, 283 (2d Cir. 1974). There can be no dispute over the fact that when petitioner gave her life savings to the brokerage firm she was a "customer" protected by SIPA[10] and entitled to the insurance protection of SIPC[11] if the broker was placed in li-

10. SIPA § 6(c)(2)(A)(ii and iii), 15 U.S.C. § 78 fff (c)(2)(A)(ii and iii).

11. SIPA § 6(f)(1), 15 U.S.C. § 78fff(f)(1).

quidation. She, as an innocent unsophisticated victim, may not be stripped of this protection by the wrongful and illegal acts of the broker and the NYSE.

It is axiomatic that all statutes are to be construed in a manner that implements the true spirit and intent of the legislature; when a literal reading produces a result which is at variance with the policy of the legislation as a whole, it is the purpose of the statute that controls. *United States* v. *American Trucking Assoc.*, 310 U.S. 534, 543-544, 84 L. Ed. 1345, 1351 (1940). Securities legislation, enacted to protect the public from fraudulent practices, should not be construed technically and restrictively, but flexibly to effectuate its remedial purposes. *Securities and Exchange Comm.* v. *Capital Gains Research Bureau*, 375 U.S. 180, 194-195, 11 L. Ed. 2d 237, 247-248 (1963).

The opinions of the District and Circuit Court are based upon a strict literal interpretation of SIPA § 6(c)(2)(A)(ii) and are therefore in conflict with the above cited Opinions of this Court. By allowing an unscrupulous securities broker's illegal actions and an exchange's wrongful conduct, to strip an innocent unsophisticated investor of the protection which Congress intended to, and did confer upon the investor, the District and Circuit Courts have encouraged the very type of conduct which the securities laws are designed to prevent. By those decisions the protection which the securities regulations were designed to afford were rendered meaningless and illusory.

## C.

### The Securities Regulatory System May Not Profit From Its Own Wrongful Conduct At The Expense Of An Innocent Unsophisicated Investor.

As previously discussed the New York Stock Exchange (NYSE) and the Securities Investor Protection Corporation (SIPC) are integral parts of a single system which Congress created to protect investors. The NYSE, under the authority granted by Section 6 of the Securities Exchange Act, is supposed to protect investors by regulating the conduct of its members through its enforcement power. When regulation is insufficient to adequately protect investors, SIPC, out of its fund, is supposed to reimburse investors' losses up to the statutory limit. Since the basic source of the SIPC fund consists of member assessments[12], which NYSE collects as agent for SIPC,[13] it is obvious that Congress intended the brokerage industry itself, through SIPC, rather than the innocent victimized investor, to bear the losses resulting from broker-dealers' insolvencies.



In the present case petitioner's loss of her entire life savings occurred as a direct result of the NYSE, the enforcement arm of the system, both permitting and wrongfully approving an illegal act against an innocent, unsophisticated investor. The District and Circuit Court opinions, which deny petitioner customer protection, permit the insurance branch of the system to profit from the wrongful acts of the enforcement branch at the expense of innocent investors.

SIPC will not only retain the monies which Congress intended petitioner to have, but SIPC will actually receive a larger portion of the money which the broker fraudulently obtained from her than any other creditor. SIPC, as subrogee of customers' claims it has paid,[14] has claims of more than thirteen times the combined amount of the unsatisfied claims of all other customers.[15] Since included in

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12. SIPA § 4(c), 15 U.S.C. § 78ddd. § 4(c).
13. SIPA § 9(a), 15 U.S.C. § 78iii § 9(a).
14. SIPA § 6(f)(1), 15 U.S.C. § 78fff(f)(1).
15. This figure is taken from page 29 of the brief respondents filed in the Second Circuit Court of Appeals.

the assets of the brokerage firm is the money which was illegally obtained from petitioner, under the lower Courts' decisions SIPC will profit more than any other party from NYSE's wrongful approval of an illegal securities sale, and this profit will be at the expense of an innocent investor.

In *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 364, 10 L. Ed. 2d 389, 404 (1963), this Court, discussing the self-regulation of the securities industry, said:

> Congress in effecting a scheme of self-regulation designed to insure fair dealing cannot be thought to have sanctioned and protected self-regulative activity when carried out in a fundamentally unfair manner.

The result reached here is not only fundamentally unfair and legally untenable, but it exacerbates the industry regulation problem. While it is desirable to protect the SIPC fund, it should be protected by better industry regulation which will result in fewer investors' losses. Allowing the brokerage industry to profit from its own wrongful acts will only encourage their repetition and lax regulation. The ramifications of such a result are obvious and, it is respectfully submitted, should be rectified by this Court.

## D.

### The Lower Courts' Summary Denial Of Petitioner's Common Law And State Remedies Erroneously Deprived Petitioner Of Remedies Which Congress Plainly Preserved.

The enactment of SIPA did not destroy Petitioner's right to utilize her common law and state statutory remedies entitling her to the return of the money of which she was illegally deprived. All laws promulgated for the protection of the securities investor are in *pari materia* and



must be read together. Section 16 of the Securities Act of 1933 (15 U.S.C. § 77p) declares expressly that the rights and remedies provided in the statutes dealing with the protection of securities investors and holders "shall be in addition to any and all other rights and remedies that may exist . . . at law or in equity". The lower courts have completely ignored that statutory provision by denying, in a summary fashion, any relief to petitioner to which she had been entitled due to the fraud and deceit practiced by the broker. In particular, the Court of Appeals misapprehended the whole theory of a constructive trust by holding that there was no *res*—a segregated fund or property—to which the trust could attach. In making that determination, the Court simply ignored well established principles of law as well as its own previous decisions and those of other circuits. The *res* in a constructive trust instance is any fund in which the moneys of the wronged party have been placed, even though the wrongdoer had commingled these moneys with its own or those of other persons. Although the constructive trust as a "fraud-rectifying" device becomes effective only by imposition of the courts, it relates back to the time of the original wrongdoing. Here the Trustee has admitted that the petitioner's moneys became part of the broker's working capital. Some of that capital was in existence at the time of the commencement of the liquidation proceedings, and still is. Under these circumstances, petitioner is entitled to either a portion of the commingled fund proportioned to her contribution thereto, or to an equitable lien on the entire fund for the amount of her money. *Marcus* v. *Otis,* 168 F. 2d 649, reaff'd 169 F. 2d 148 (2d Cir. 1948); *In re Blue Bird Appliance Co.,* 292 F. 127, 128 (8th Cir. 1923); *Grodsky* v. *Sipe,* 30 F. Supp. 656 (E.D. Ill. 1940); *Primeau* v. *Gran-*

*field* (decision by Judge Learned Hand), 184 F. 480 (S.D.N.Y. 1911), *rev'd on another ground* 193 F. 911 (2d Cir. 1911), *cert. den.*, 225 U.S. 709 (1912); *Erie Trust Company's Case,* 326 Pa. 198, 191 A. 613 (1937); *Burket* v. *Bank of Hollywood,* 9 Cal. 2d 113, 69 P. 2d 421 (1937); *In re Oatway,* [1903] 2 Ch. 356; Rest. Restitution § 209.

The denial of a constructive trust by the lower courts in the present case constitutes a violation of the policies and principles envisaged by Congress in enacting the various securities laws since Congress intended that the defrauded investor should have the whole arsenal of common law remedies available to him in order to avert the detrimental effect of securities frauds upon the economy.

Moreover, the practices engaged in by the stockholder were also violative of pertinent Illinois State statutes. Under Section 18 of the Securities Act (15 U.S.C. § 77r), state authorities may exercise concurrent jurisdiction with the federal authorities; hence the pertinent provisions of the Illinois Securities Law (Ill. Rev. Stat. ch. 121½, § 137.12) and the Illinois Consumer Fraud Act (Ill. Rev. Stat. ch. 121½, § 262) are equally applicable with regard to the activities of the stockbroker who engaged in the deceitful practices. (See *Merrill Lynch, Pierce, Fenner & Smith Inc.* v. *Ware,* 414 U.S. 117, 123, 128, 129, 130, 137, 38 L. Ed. 2d 348 ,359, 360, 361, 364, 365 (1973); *Crosby* v. *Weil,* 382 Ill. 538, 48 N.E. 2d 386 (1943); and *Travelers' Health Assn.* v. *Comm.* 188 Va. 877, 51 S.E. 2d 263 (1949), *aff'd.* 339 U.S. 643, 94 L. Ed. 1154 (1950). Here again, the lower courts, in denying petitioner's claim, in effect, deprived petitioner of remedies which Congress in its securities regulations plainly preserved.



## CONCLUSION

Since the public interest is vitally affected and the decisions of the lower courts are fraught with grave consequences, particularly for the small, unsophisticated investor in the securities market, and, therefore, the national economy—consequences which by far transcend the factual confines of the case at bar—it is respectfully asked that a writ of certiorari be issued to review the judgment and opinion of the Second Circuit.

Respectfully submitted,

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## APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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# APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

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Nos. 36, 37, 39, 40, 41, 42—September Term, 1977.

(Argued October 21, 1977 Decided June 12, 1978.)

Docket Nos. 77-6034, 77-6038, 77-6044, 77-6045, 77-6048, 77-6065

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In the Matter of

WEIS SECURITIES, INC.,

*Debtor.*

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GEORGE D. ALDRICH, H. WALLACE COHU, JOHN DE BRAGANCA, JAMES J. HIGGINSON, GRACE CUTTING MCGRATH, GRACE M. MCGRATH, CRAIG K. MITCHELL, EUGENE W. STETSON, JR., JEAN M. WINSLOW, SAMUEL WINSLOW, ESTATE OF PHILLIP D. HOLDEN, deceased, FIDELITY CORP., GENERAL UNITED LIFE INSURANCE CO., ALL AMERICAN LIFE & CASUALTY CO., ROBERT SLATER, EVA GROSSMAN, ARTHUR KREIZEL, and WEIS VOISIN & CO., INC. EMPLOYEES' PROFIT-SHARING PLAN AND TRUST,

*Claimants-Appellants,*

v.

EDWARD S. REDINGTON, TRUSTEE, and SECURITIES INVESTOR PROTECTION CORPORATION,

*Appellees.*

---

Before:

WATERMAN, MULLIGAN and TIMBERS,

*Circuit Judges.*

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TIMBERS, *Circuit Judge:*

The chief question presented on this appeal is whether the claims of certain subordinated *lenders* to a broker-dealer now in liquidation should be enforced in accordance with the subordination agreements to which the lenders were parties, regardless of whether *customers* of the broker-dealer could show reliance on the subordination agreements. We hold that such subordination agreements must be enforced in accordance with their terms.

The appeal is from a judgment entered January 20, 1977 in the Southern District of New York, Inzer B. Wyatt, *District Judge,* 425 F. Supp. 212, which upheld the trustee's position with respect to the claims of the subordinated lenders. In so doing, Judge Wyatt reversed an order of Roy Babitt, *Bankruptcy Judge,* which had denied the trustee's motion for summary judgment. Judge Wyatt directed that the matter be remanded to the bankruptcy court for furthur proceedings consistent with Judge's Wyatt's opinion. We agree with the trustee's position as upheld by Judge Wyatt. We affirm.

## I.

In summarizing those facts and prior proceedings necessary to an understanding of our rulings on the legal issues presented, we assume familiarity with Judge Wyatt's clear, comprehensive opinion cited above.

The proceedings in the district court began as an enforcement action commenced May 23, 1973 by the Securities and Exchange Commission (SEC) against Weis Securities, Inc. (Weis) pursuant to Section 21(e) of the Securities Exchange Act of 1934[1] and Section 20(b) of

1. 15 U.S.C. § 78u(e) (1970) [now Section 21(d), 15 U.S.C. § 78u(d) (1976)].



the Securities Act of 1933.[2] In that action[3] the SEC's complaint sought to enjoin Weis and certain of its officers from continuing violations of the antifraud and net capital provisions of the Exchange Act[4] and the Commission's rules thereunder.[5] The SEC's complaint also requested the appointment of a temporary receiver for the assets and the books and records of Weis.

On May 24, the day after the SEC enforcement action was commenced, the Securities Investor Protection Corporation (SIPC) filed an application in the SEC action, pursuant to § 5(a)(2) of the Securities Investor Protection Act of 1970 (SIPA),[6] requesting that the court adjudicate under § 5(b)(1) that the customers of Weis were in need of the protection afforded by SIPA and that the court appoint a trustee and an attorney under § 5(b)(3). See *SEC* v. *Alan F. Hughes, Inc.,* 461 F. 2d 974 (2 Cir. 1972).

On May 30 the court (then District Judge, now Circuit Judge, Murray I. Gurfein) made the requested adjudica-

2. 15 U.S.C. § 77t(b) (1970) [now Section 20(b), 15 U.S.C. § 77t(b) (1976)].

3. The jurisdictional underpinning for the action is provided in Section 27 of the Exchange Act, 15 U.S.C. § 78aa (1976), and Section 22(a) of the Securities Act, 15 U.S.C. § 77v(a) (1976).

4. Sections 10(b) and 15(c)(3), 15 U.S.C. §§ 78j(b) and 78o(c)(3) 1976).

5. Rules 15c3-1, 17a-3, 17a-4, 17a-5 and 17a-11, 17 CFR §§ 240.15c3-1, 240.17a-3, 240.17a-4, 240.17a-5, 240.17a-11 (1977).

6. 15 U.S.C. § 78eee(a)(2) (1976).

Unless otherwise indicated, all citations to SIPA are to sections thereof, as here, e.g., to § 5(a)(2). SIPA has been codified at 15 U.S.C. §§ 78aaa-78lll (1976).

tion. He appointed Edward S. Redington as trustee to oversee the orderly liquidation of the remaining assests of Weis. The proceedings in which Mr. Redington was appointed as trustee are more fully set forth in *Exchange National Bank of Chicago* v. *Wyatt,* 517 F. 2d 453, 455 (2 Cir. 1975) (Friendly, *J.*).

Backing up for a moment, during the period from June 28, 1967 to May 7, 1973, each of the lenders here involved entered into agreements with Weis which subordinated their accounts with, or loans to, Weis, to the claims of all creditors of Weis—both then existing creditors and future ones as well. In connection with all such subordination agreements the lenders submitted for approval written applications to the Board of Governors of the New York Stock Exchange (NYSE), together with opinions of counsel stating that the subordination agreements were valid and enforceable.

In consideration of the added risks inherent in the subordination, the agreements provided that the lenders were to receive interest at attractive rates on the principal amounts of the loans. As a group, the lenders received under the subordination agreements approximately $750,000 in interest.

The subordination agreements were important in that they enabled Weis to comply with the net capital rules of the SEC[7] and of the NYSE,[8] and thus to continue to deal

7. Rule 15c3-1(a) under the Exchange Act, 17 CFR § 240.15c3-1(a) (1977), provides:

"No broker or dealer shall permit his aggregate indebtedness to all other persons to exceed 1500 percentum of his net capital, except as otherwise limited by the provisions of subparagraph (a)(1), or, in the case of a broker or dealer electing to operate pursu-

*(Footnote continued on next page)*



with the public. The purpose of the net capital rules is "to require that the capital position of a broker or dealer will always be sufficiently liquid to cover his current indebtedness, in order to be able at all times to promptly

*(Footnote continued from preceding page)*

ant to paragraph (f) of this section, no broker or dealer shall permit his net capital to be less than 4 percent of aggregate debit items as computed in accordance with § 240.15c3-3a of this Chapter, except as otherwise limited by paragraph (f) of this section, and every broker or dealer shall have the net capital necessary to comply with the following conditions, except as otherwise provided for in paragraph (f) of this section."

8. NYSE Rule 325 in relevant part provides:

"(a) Each member or member organization subject to Rule 15c3-1 promulgated under the Securities Exchange Act of 1934 shall comply with the capital requirements prescribed therein and with the additional requirements of this Rule 325.

(b) Each member or member organization subject to this Rule shall forthwith notify the Exchange if his or its net capital after deduction of all capital withdrawals including maturities, if any, scheduled during the next six months, falls below the pertinent percentage indicated below:

1. If the net capital minimum dollar amount requirement is applicable—150 percent thereof or some greater percentage as may from time to time be designated by the Exchange, or
2. If the ratio of aggregate indebtedness to net capital is applicable—10 percent of aggregate indebtedness, or
3. If the specified percentage of the aggregate debit items in the Formula for Determination of Reserve Requirements for Brokers and Dealers under Securities and Exchange Commission Rule 15c3-3 is applicable—7 percent of the aggregate items thereunder. . . ."

meet the demands of customers." Securities Exchange Act Release No. 8024 (Jan. 18, 1967). Specifically, the net capital rules limit the aggregate indebtedness of regulated member firms to fifteen times their net capital. If the appropriate ratio is not met, the broker or dealer may not continue operations. In computing a firm's net capital (net worth minus nonliquid assets), subordinated property is not treated as a liability against the firm, but as an unencumbered capital asset. This treatment of subordinated property as an unencumbered asset is predicated on the assumption that such property is readily available to satisfy customers' claims.

In the instant case, the subordination agreements constituted a substantial part of Weis' net capital. As such, they were a *sine qua non* of Weis' compliance with the net capital rules and of the firm's being permitted to continue to deal with the public.

After Weis' fraud was disclosed, the lenders attempted to rescind their subordination agreements. They claimed that they had been fraudulently induced to enter into the agreements in violation of common law and the Exchange Act.[9] Such rescission, if permitted, would have placed the lenders in the same position in the liquidation proceeding as unsubordinated creditors and customers.

The trustee moved in the bankruptcy court for summary judgment to enforce the subordination agreements on the ground that the lenders were estopped from rescinding the agreements, regardless of whether customers and general creditors had relied on the agreements. For purposes of the motion, it was assumed that Weis fraudulently had induced the lenders to enter into the agreements.

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9. Section 10(b), 15 U.S.C. § 78j(b) (1976), and Rule 10b-5, 17 CFR § 240.10b-5 (1977).



In an opinion filed July 16. 1976 the bankruptcy judge denied the trustee's motion. The judge held that reliance by customers and creditors would give rise to an estoppel which would bar rescission; but whether there had been such reliance was a question of fact which precluded summary judgment. From the order entered in the bankruptcy court on August 23, 1976 denying summary judgment, the trustee appealed to the district court.

In an opinion filed January 20, 1977, Judge Wyatt reversed the bankruptcy court's denial of summary judgment, holding that reliance by customers and creditors, if necessary at all, should be conclusively presumed as a matter of law; and that the subordination agreements should be enforced according to their terms in distributing the assets of Weis. *In the Matter of Weis Securities, Inc.*, 425 F. Supp. 212, 217 (S.D.N.Y. 1977).

For reasons stated more fully below, we agree with Judge Wyatt that *customers* of Weis need not show reliance on the subordination agreements to prevent rescission by the lenders. Since the remaining assets of Weis will be exhausted after satisfaction of the customers' claims, it is unnecessary to reach the question whether *general creditors* must prove reliance in order to prevent rescission. We find no merit in the separate claims raised by several of the appellants referred to below. We affirm the judgment of the district court in all respects.

## II.

In the light of the foregoing summary of the facts and prior proceedings, we turn directly to the issue which is common to all appellants:[10] whether the claims of subordi-

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10. We shall discuss below the separate claims raised by appellants Eva Grossman; Weis, Voisin & Co., Inc. Employees' Profit-Sharing Plan and Trust; and Fidelity Corporation.

nated lenders to a federally regulated broker-dealer now in liquidation should be enforced in accordance with the subordination agreements to which the lenders were parties, regardless of whether customers of the broker-dealer could show reliance on the subordination agreements as a condition to estopping the lenders from rescinding the agreements on grounds of fraud.

The lenders contend that they may not be prevented from rescinding on the basis of fraud unless the customers can show reliance on the situation that turns out to be fraudulent. We recognize that proof of detrimental reliance may be a prerequisite to the application of the doctrine of estoppel. *E.g., Fey* v. *Walston & Co., Inc.*, 493 F. 2d 1036, 1050 (7 Cir. 1974); *Royal Air Properties, Inc.* v. *Smith*, 333 F. 2d 568, 570 (9 Cir. 1964). In this Circuit, the principle was applied in *In re Credit Industrial Corp.*, 366 F. 2d 402 (2d Cir. 1966). There junior creditors sought priority in a bankruptcy proceeding because of the illegality of the agreement under which they had subordinated their interests. We stated the standard for requiring reliance as follows:

> "Reliance may become a relevant factor where equitable considerations require its consideration, namely, where the subordination agreement itself is invalid. . . . When a junior creditor establishes that the subordination agreement is unlawful, *it may be reasonable and necessary*, if equity is to be done, to require a senior creditor to prove that he relied on the subordination agreement, without actual or constructive knowledge of any infirmity in the agreement, in advancing funds to the bankrupt as a condition to receiving priority in the distribution of the bankrupt's estate. In cases where the underlying subordination agreement is unlawful, a court is not confronted with the problem of enforcing express contractual provisions but, rather, with the entirely separate problem of determining which general creditors should bear a loss caused by the debtor, a problem which *may* have to be resolved by reference to equitable principles." (emphasis added) (citations omitted).

*Id.* at 409.



Unlike *Credit Industrial Corp.*, however, the instant case involves the attempted rescission of a promise or obligation intended to allow a company to satisfy regulatory requirements and of promises made by the company to regulatory authorities. We therefore have an additional factor —regulatory interest—to consider in determining whether it is here "reasonable and necessary" to require reliance on the subordination agreements. Our inquiry must focus on whether the element of reliance has any place in the regulatory scheme of Congress.

In this connection we find relevant, as the district court did, a series of cases arising under the National Banking Act. Prior to 1959, shareholders of a national bank were statutorily liable for all obligations of the bank to the extent of the par value of their shares.[11]

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11. Section 63 of the National Banking Act, 12 U.S.C. § 63 (1958) [repealed in 1959], in relevant part provided:

> "The shareholders of every national banking association shall be held individually responsible . . . for all contracts, debts, and engagements of such association, to the extent of the amount of their stock therein, at the par value thereof, in addition to the amount invested in such shares. . . ."

The lenders argue that this statute is distinguishable from the federal securities laws in that the former's "clear language" imposed an "absolute liability" on the stockholders. There is no basis for this distinction. The National Banking Act did not refer to the fraudulent inducement of contributions to required capital amounts any more explicitly than the Exchange Act does.

In *Scott* v. *Deweese,* 181 U.S. 202 (1901), such a shareholder sought to rescind his purchase of bank stock on the ground that he had been fraudulently induced by the bank to buy his shares. The Court held that he was estopped from doing so on the ground that one who purchased bank shares must be conclusively presumed to have known that he had increased the bank's capital and had facilitated its conduct of business. *Id.* at 212. The Court was careful to point out that the congressional policy reflected in the statute required a bright-line delineation of priority:

> "The present suit is primarily in the interest of creditors of the bank. It is based upon a statute designed not only for their protection but to give confidence to all dealing with national banks in respect of their contracts, debts and engagements( as well as to stockholders generally. If the subscriber became a shareholder in consequence of frauds practised upon him by others, whether they be officers of the bank or officers of the Government, he must look to them for such redress as the law authorizes, and is estopped, as against creditors, to deny that he is a shareholder, within the meaning of section 5151, if at the time the rights of creditors accrued he occupied and was accorded the rights appertaining to that position."

*Id.* at 213. Whether the bank creditor had relied on the bank's capitalization was irrelevant. *Accord, Anderson* v. *Cronkleton,* 32 F. 2d 170, 172-73 (8 Cir. 1929) ("The statute . . . serves a general public purpose, viz., to give stability to the national banking system . . . . If stockholders were permitted to show . . . , in order to escape liability under the statute, that they became stockholders through fraud . . . the foundation of a national bank would be undermined, and its public function impaired.") *Cf.*



*Hurd* v. *Kelley,* 78 N.Y. 588, 597 (1879) (same with respect to a New York state bank).[12]

In these cases the courts recognized a legislative intent to encourage the public transactions upon which the well-being of the economy largely depends by bolstering public confidence in the integrity of financial institutions. To assure creditors that they could rely on the stated capital resources of a bank, the legislature compelled those who had contributed capital to stand by their commitments. In order faithfully to effectuate the legislative policy, the courts held that no condition should be placed on the creditors' priority; they concluded that shareholders were absolutely estopped from rescinding their obligations.

The same legislative solicitude for the interests of customers is present in the instant case. As stated above, pursuant to its congressional mandate to police the integrity of the nation's securities markets, the SEC has promulgated a rule which makes the ability of a securities broker to conduct business contingent upon the main-

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12. *Oppenheimer* v. *Harriman National Bank & Trust Co.,* 301 U.S. 206 (1937), relied upon by the lenders, is not to the contrary. There the Court held that a defrauded stockholder was entitled to rank on a parity with other unsecured creditors. *Id.* at 215. However, this right was held to have accrued only after vindication of regulatory interests by his payment of the statutory liability to those creditors:

> "Plaintiff appeared by the bank's records to be a stockholder and, as against creditors for whose benefit the statutory liability was created, was estopped from denying that status. Recognizing that the bank's fraud and his rescission availed nothing against the comptroller's assessment, plaintiff paid the amount laid against him." *Id.* at 214.

tenance of certain capital levels. In the same net capital rule, the SEC has proscribed the rescission of subordinated loan agreements "by mutual consent or otherwise."[13] At least to the same extent as under the National Banking Act, the regulatory authorities here are motivated by a strong desire to assure investors of the stability and integrity of the securities markets and of the broker-dealers responsible for channeling investments into them. As with the courts which interpreted the National Banking Act, we find no suggestion of a congressional intent to make the priority to which customers of a broker-dealer are entitled contingent on anything—and certainly not on the necessity of proving reliance on specific elements of a broker-dealer's assets. In short, we decline to blur the bright-line rule fashioned to further a public objective of the utmost importance.

Our holding in this respect is grounded on considerations of sound public policy. As the SEC points out in its excellent brief, to require proof of actual reliance would exacerbate the problem of impermanent capital in the brokerage community—one of the more significant causes of broker-dealer failures during the 1969-70 period. Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 231, 92d Cong., 1st Sess. 49 (1971). Moreover, there would be continuing uncertainty as to the financial responsibility of broker-dealers whose capital rests on subordination agreements.

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13. Rule 15c3-1d(c)(1), 17 CFR § 240.15c3-1d(c)(1) (1977).

Weis was not formally subject to this rule because the SEC found that it was subject to NYSE Rule 325, which is even more comprehensive than the SEC rule. Securities Exchange Act Release No. 3617, Nov. 8, 1944).



In view of these considerations, sanctioning a reliance requirement in the instant case would be inconsistent with *In re Credit Industrial Corp., supra.* Proof of reliance here clearly is not "reasonable or necessary." 366 F. 2d at 409. To hold otherwise, in the asserted exercise of our equitable powers, would be contrary to public policy.

We hold, under this section of our opinion, that where a lender subordinates his loan to a securities broker—to enable the broker to comply with regulatory capital requirements—he is estopped from rescinding the subordination agreement. Whether customers relied on the subordination agreement is irrelevant. We affirm Judge Wyatt's holding on this issue.

## III.

We turn next to the separate claims raised by certain of the appellants. See note 10, *supra.*

### (A) Claim of Appellant Eva Grossman

First, Mrs. Grossman contends that, because of her asserted lack of sophistication in financial matters, as a lender she should have been treated differently from the other lenders by the district court. She works as a fitter in a Chicago department store. She says that when she purchased 20,000 of Weis subordinated debentures she did not fully understand the benefits and risks of her investment. She concedes that she did know that her investment as a loan to Weis would return about the highest rate of interest of any investment she could make. At oral argument before us, her attorney acknowledged that she had received several thousand dollars in interest during the six years she had owned the debentures prior to the liquidation of Weis. She nevertheless argues that, because of her peculiar lack of sophistication, she never became

a party to a subordinated debenture agreement; and that she actually was a general creditor or customer of Weis within the meaning of § 6(c)(2)(A)(ii) of SIPA.[14] We find no merit in this contention and hold that there is no basis for treating Mrs. Grossman any differently than the other lenders.

Second, Mrs. Grossman contends that, since all the assets of Weis, Voisin, Cannon Inc. (the predecessor of Weis) were transferred to Weis without notice to her, such transfer violated the Illinois and New York Bulk Sales Acts. Ill. Rev. Stat. ch. 26, §§ 6-101 et seq.; N.Y. U.C.C. §§ 6-101 et seq. If the Bulk Sales Acts were applicable, noncompliance with their terms would render the transfer voidable at Mrs. Grossman's option. *Corrigan* v. *Miller*, 338 Ill. App. 212, 217, 86 N.E. 2d 853, 856 (1949). We hold, however, that neither Bulk Sales Act is applicable here. Both Acts are intended to apply only to enterprises "whose principal business is the sale of merchandise from stock. . . ." N.Y. U.C.C. § 6-102(3); Ill. Rev. Stat. ch. 26 § 6-102(3). Weis was a broker engaged in transactions which involved investment securities. It did not sell goods or merchandise. See N.Y. U.C.C. § 8-102; Ill. Rev. Stat. ch. 26, § 8-102. We therefore find no merit in this contention.

Third, Mrs. Grossman contends that under common law the funds which she says Weis fraudulently induced her to subordinate are held by Weis and its successors under a constructive trust for her benefit. It is elementary, however, that before a constructive trust may arise, there must be a *res*—a segregated fund or property—to which the trust can attach. *A.L.I., Restatement of Restitution § 160. comment i (1937)*. Here there was nothing more than the opening of an account for Mrs. Grossman. No funds were

14. 15 U.S.C. § 78fff(c)(2)(A)(ii) (1976).



segregated for her account. Absent a *res*, there could be no constructive trust. We therefore find no merit in this contention.

We have carefully considered the other arguments urged by Mrs. Grossman and find them to be without merit.

(B) Claim of Appellant Weis, Voisin & Co. Inc. Employees' Profit-Sharing Plan and Trust

Weis, Voisin & Co. Inc. Employees' Profit-Sharing Plan and Trust (the Trust) is a tax-qualified retirement plan which provided part of the compensation, paid by Weis in the form of contributions, for eligible Weis employees. The Trust used these funds to extend a total of $95,000 in subordinated loans to Weis. Under the terms of the liquidation of Weis, the Trust will be terminated and the employees will receive a distribution of their interest in its assets.

The Trust contends that the subordinated loans it made to Weis are in substance wages owed by Weis, through the Trust, to eligible former employees. Accordingly, it asks us to accord to such loans the priority status conferred on "wages" by Section 64(a)(2) of the Bankruptcy Act, 11 U.S.C. § 104(a)(2) (1976).

The district court held, 428 F. Supp. at 219, that the term "wages" in this context is limited to "money directly due [employees] in back wages", citing *United States* v. *Embassy Restaurant*, 359 U.S. 29, 32 (1959); and that a contract whereby an employees' trust loans money to an employer at higher than normal interest rates in consideration of subordination is not within the classic pattern of "back wages". We agree.

(C) Claim of Appellant Fidelity Corporation

On January 21, 1971, Fidelity Corporation (Fidelity) entered into an agreement with Weis pursuant to which

Fidelity extended a $1,000,000 loan in consideration of a subordinated promissory note and an undertaking by Weis to sell insurance exclusively for Fidelity. Beginning October, 1972 Weis sold insurance for others in violation of this agreement. On October 12 Weis entered into a new agreement with Fidelity to repay the entire loan on November 2, 1972. When the repayment became due, Weis refused to pay it.

Fidelity contends that it may claim rescission of its subordination agreement, not only on grounds of fraud, but also on grounds of material breach of contract and failure of consideration. It urges that it should be treated as an unsecured general creditor. Alternatively, it contends that the new unsubordinated agreement of October 12 should place it in the position of a general creditor.

We hold that Fidelity, whose claim is conditioned upon a subordination agreement, is in the same position as the other lenders; and that its arguments based on breach of contract and failure of consideration are without merit.

We have carefully considered all claims of all appellants, and we find them without merit.

Affirmed.



UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the seventh day of August, one thousand nine hundred and seventy-eight.

Present:

HON. STERRY R. WATERMAN
HON. WILLIAM H. MULLIGAN
HON. WILLIAM H. TIMBERS
*Circuit Judges.*

———————X

On the Matter of Weis Securities, Inc.,
Debtor

Claims of Docket No. 77-6034

EVA GROSSMANN, ALL AMERICAN LIFE & CASUALTY CO., GENERAL UNITED LIFE INSURANCE CO., ROBERT E. SLATER, GEORGE ALDRICH, H. WALLACE COHU, JOHN DEBRAGANCA, JAMES J. HIGGINSON, GRACE CUTTING McGRATH, GRACE M. McGRATH, CRAIG K. MITCHELL, EUGENE W. STETSON, JR., JEAN M. WINSLOW, SAMUEL WINSLOW, MICHAEL HALE HOLDEN CHEMICAL BANK, FIDELITY CORP., WEIS, VOISIN & CO., INC., EMPLOYEES' PROFIT SHARING PLAN & TRUST, ARTHUR J. KREIZEL OF STOWE, VT., Claimant-Appellants

EDWARD REDINGTON, TRUSTEE & SECURITIES INVESTOR PROTECTION CORP., Appellees.

———————X

A petition for a rehearing having been filed herein by counsel for the Claimant-appellant, Eva Grossman,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

s/ A. DANIEL FUSARO,
A. DANIEL FUSARO,
Clerk.

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the seventh day of August, one thousand nine hundred and seventy-eight.

———————X

In the Matter of Weis Securities, Inc.,
Debtor

Claims of Docket No. 77-6034

EVA GROSSMANN, ALL AMERICAN LIFE & CASUALTY CO., GENERAL UNITED LIFE INSURANCE CO., ROBERT E. SLATER, GEORGE ALDRICH, H. WALLACE COHU, JOHN DEBRAGANCA, JAMES J. HIGGINSON, GRACE CUTTING McGRATH, GRACE M. McGRATH, CRAIG K. MITCHELL, EUGENE W. STETSON, JR., JEAN M. WINSLOW, SAMUEL WINSLOW, MICHAEL HALE HOLDEN CHEMICAL BANK, FIDELITY CORP., WEIS, VOISIN & CO., INC., EMPLOYEES' PROFIT SHARING PLAN & TRUST, ARTHUR J. KREIZEL OF STOWE, VT., Claimant-Appellants

EDWARD REDINGTON, TRUSTEE & SECURITIES INVESTOR PROTECTION CORP., Appellees.

———————X

A petition for rehearing containing a suggestion that the action be reheard en banc having been filed herein by counsel for the Claimant-appellant, Eva Grossman, and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

s/ IRVING R. KAUFMAN,
IRVING R. KAUFMAN,
Chief Judge.



In the Matter of WEIS SECURITIES, INC., Debtor.

Claims of George D. ALDRICH, et al.

No. 73 Civ. 2332.

United States District Court,
S. D. New York.

Jan. 20, 1977.

WYATT, District Judge.

These are two appeals from an order of Bankruptcy Judge Babitt filed August 26, 1976. Appellants are (a) the trustee for the liquidation of the business of Weis Securities, Inc. (Weis) under the Securities Investor Protection Act of 1970 (SIPA, 15 U.S.C. § 78aaa and following) and (b) the Securities Investor Protection Corporation (SIPC). The order appealed from denied a motion of the trustee for summary judgment sustaining his objections to the claims of 24 different claimants who were subordinated lenders to Weis (sometimes called "claimants" and sometimes "subordinated lenders"). A thoughtful opinion had been filed by the Bankruptcy Judge on July 16, 1976. I am persuaded, however, that the able Bankruptcy Judge was in error and that the order appealed from must be reversed.

1

Weis had been a prominent registered broker-dealer and a member of the New York Stock Exchange.

The proceedings in which the trustee was appointed are described in *Exchange National Bank* v. *Wyatt*, 517 F. 2d 453 (2d Cir. 1975). The trustee was appointed on May 30, 1973; the "filing date" (15 U.S.C. § 78eee(b)(4)(B)) was May 24, 1973. Weis was in liquidation under SIPA.

2

The securities business is much regulated, necessarily so after the 1929 stock market crash and the conditions which preceded it.

The Securities Exchange Act of 1934 (15 U.S.C. § 78a and following; the 1934 Act) required brokers to have a certain amount of capital. Section 8(b) of the 1934 Act (15 U.S.C. § 78h(b)) required that the capital of a broker firm be at least 1/20 the amount of the total indebtedness of the broker firm. Expressed another way, the 1934 Act was designed to protect the customers of a broker against his insolvency; this was to be done, among other ways, by preventing him from borrowing more than twenty times his net capital.

The New York Stock Exchange had its own rule as to net capital requirements. This was its Rule 325 which provided that the indebtedness of a member could not be more than 15 times the net capital of such member.

In 1938, the 1934 Act was amended to give the SEC authority to issue regulations with respect to the "financial responsibility" of brokers. 15 U.S.C. § 78o(c)(3). The SEC issued a regulation (17 CFR § 240.15c3-1) which provided that no broker could have indebtedness of more than 20 times his net capital. Because the New York Stock Exchange rule was more restrictive than this, the SEC reguation was not applicable to members of that Exchange. Weis was a member of the New York Stock Exchange.

3

In meeting the net capital requirements of the SEC and of the Exchange, the practice developed of brokers borrowing money on a subordinated basis, that is, the lenders



agreed that their claims would be subordinated to general creditors. Where such agreements were approved by the Exchange, the indebtedness was excluded in calculating compliance with the net capital rule of the Exchange. This was an explicit provision of Rule 325(b)(2)(E) of the Exchange, which excluded from the aggregate indebtedness of a member "liabilities subordinated to general creditors pursuant to a separate agreement approved by the Exchange". In substance the subordinated loans, with the knowledge of the lenders, were used as capital for purposes of the net capital rules.

Weis, in attempting to comply with the net capital rules, borrowed from lenders who agreed that their claims would be subordinated to the general creditors of Weis. Also Weis had in 1969 bought certain assets from another broker-dealer, Winslow, Cohu & Stetson Incorporated ("Winslow"). Winslow was a member of the New York Stock Exchange and had borrowed from subordinated lenders.

It should be obvious, but may bear mentioning, that subordinated lenders are paid for the added risks which they knowingly assume. They receive all income from all securities loaned, in addition to interest at rates usually above normal. Here, for example, Weis undertook to pay 10% interest to most of the lenders and not less than 8%. We are told that in fact Weis paid $750,000 to these lenders before the trustee was appointed.

4

After the trustee was appointed for Weis on May 30, 1973, claims were filed by some 50 subordinated lenders to Weis.

On April 24, 1974, the trustee filed an "application for an order confirming the trustee's position with respect to

claims of subordinated lenders". This position was that the subordination agreements should be enforced in accordance with their terms, that claims of fraud by the subordinated lenders even if proved would not avoid the subordination agreements because every customer and creditor of Weis had relied on those agreements "either expressly or constructively", and that the claims of subordinated lenders to Weis should not be paid until the general unsecured creditors of Weis had been paid in full.

On April 24, 1974, Judge Babitt made and filed an order requiring the subordinated lenders and SEC and SIPC to show cause why the trustee's position should not be sustained.

This order to show cause was heard on July 16, 1974. Many of the subordinated lenders did not appear to oppose the position of the trustee. As to these, there was an "inquest" and the trustee's position as to them was sustained and this proceeding is no longer concerned with them.

As to 24 subordinated lenders who opposed the trustee's position, objections to their claims were then served by the trustee and filed on December 12, 1974.

Judge Babitt then made an order on December 13, 1974 requiring the 24 subordinated lenders to show cause why summary judgment should not be granted on the objections of the trustee to their claims and why the trustee's position should not be confirmed.

The hearing on this order to show cause was held on March 12, 1975.

On July 16, 1976, Judge Babitt filed his opinion and on August 26, 1976, the order here appealed from was filed. The order denied the trustee's motion.





Each of the subordination agreements here in question was made with knowledge that the money (or property) loaned would be used as capital of Weis for satisfying the provisions of the net capital rules. Each provided that in any liquidation of Weis, the loan would not participate in any distribution of Weis assets until the claims of all general creditors of Weis were satisfied. Each of these lenders submitted an application to the Exchange for approval as a subordinated lender. Each of the agreements was filed with the Exchange. Each was approved by the Exchange for inclusion of the borrowed money or property in calculating the capital of Weis to determine compliance with the net capital rules. None of this was disputed before the Bankruptcy Judge. One of the subordinated lenders sought to avoid the substance of his agreements by a statement that he was "unfamiliar with such requirements" of the Exchange (Slater aff. ¶ 4). Another stated that while the papers were signed and completed for the Exchange, the details were handled by Weis (Gardner aff. ¶ 4).

Now the subordinated lenders seek to avoid their subordination agreements by the claim that they were induced by the fraud of Weis to enter into those agreements. They thus ask in effect or expressly for rescission of their agreements and return of what they loaned to Weis.

The trustee contends that even if fraud on the subordinated lenders be assumed, these lenders are estopped as a matter of law to assert it because those of the public who dealt with Weis and who are now general creditors relied on compliance by Weis with the net capital rules and such compliance was made possible only by the agreements to subordinate. The trustee also contends that the

subordination provisions were promises to the Exchange which relied on them in allowing Weis to continue as a member and to deal with those who thereby became general creditors in the present liquidation.

6

In denying the trustee's motion, Judge Babitt ruled that actual reliance by the general creditors on the subordination agreements or net capital rule must be proved by the trustee in order to defeat the claims of fraud by the subordinated lenders. Judge Babitt also ruled that if the trustee can establish "an independent contract" between the subordinated lenders and the Exchange, "that contract will remain in force regardless of any fraud perpetrated by Weis".

It is far from clear how the ruling of the Bankruptcy Judge is intended to be applied. Must the trustee prove actual reliance by each customer creditor? Would failure to prove actual reliance by any *one* customer creditor mean that the subordination agreements could be rescinded as against all customer creditors or only as to that one customer creditor as to whom there was failure of proof? We are told by the trustee that there were 30,000 customers of Weis and by SIPC that there were 33,000 such customers. Would the trustee be required to prove actual reliance on each one of the subordination agreements of each subordinated lender? What would be the effect of a failure of proof as to one subordination agreement of one subordinated lender?

Normally these questions would be reached only after a trial of the fraud issue as to each subordinated lender and after at least one subordinated lender had established fraud by Weis. As to any subordinated lender who fails to



prove fraud by Weis, the inquiry would normally be ended and the subordination agreement could be enforced according to its terms.

It seems, however, that the Bankruptcy Judge has in mind a reversal of this order of events. The trustee is first to prove reliance by the customer creditors. If he can do this, then proof of fraud will not be taken because irrelevant. If the trustee does not prove reliance, then the fraud issue is then to be tried as to each subordinated lender. If this be the contemplated procedure it seems illogical and unworkable.

It is not clear exactly what procedure is contemplated. However, the practical result of the ruling of the Bankruptcy Judge is clear. The burden of proof on the trustee could not be met as a practical matter and thus the subordination agreements, on the strength of which Weis had been allowed to continue operating and to create claims of general creditors, could not be enforced.

7

Judge Babitt concluded that "the controlling case" is *In re Credit Industrial Corp.*, 366 F. 2d 402 (2d Cir. 1966). It is believed that this conclusion is mistaken.

CIC, a commercial finance company, obtained its working capital by borrowing from (a) institutions and (b) individuals. The individual lenders were paid " a high rate (10%-12%) of interest" but their loans were agreed to be subordinated to institutional loans and not to be paid until CIC paid all its obligations to institutional lenders. CIC became a bankrupt. Its trustee sought to enforce the subordination agreement. The individual lenders asserted several *separate* defenses, two of which are significant here: (a) that the institutions did not lend to CIC in reliance

on the subordination agreement and (b) that fraud was practiced on the individual lenders. The District Court had affirmed the denial of a motion to strike the defense described in (a) and the granting of a motion to strike the defense described in (b). The District Court believed that any subordination agreement, however valid or lawful, could only be enforced in bankruptcy if actual reliance on the agreement by senior creditors could be shown. Under this belief, it was irrelevant whether fraud could be proved by the subordinated (individual) lenders because, whether there were fraud or not, reliance by the senior (institutional) lenders had to be shown.

The Court of Appeals reversed, holding that in bankruptcy the Court "must enforce lawful subordination agreements according to their terms" (366 F. 2d at 410). Therefore, the separate defense described in (a) above should have been struck.

It was also held that the separate defense of fraud described in (b) above should not have been struck because the pleading stage was too early to decide whether proof of fraud would avail the subordinated (individual) lenders; this "should await such disposition as the law and facts require after the relevant facts have been developed" (366 F. 2d at 412).

The Court of Appeals did discuss but *did not decide* whether reliance must be shown to overcome a defense of fraud asserted by junior creditors. Such a defense was allowed to be asserted as a matter of pleading because it "*may* become important to the rights of junior creditors" (366 F. 2d at 410-11; emphasis supplied); therefore "the noteholders here are entitled to assert" such a defense in their pleading (366 F. 2d at 411). Elsewhere the Court of Appeals said: "Reliance *may* become a relevant factor . . .



where the subordination agreement itself is invalid" (366 F. 2d at 409; emphasis supplied).

There was thus no decision by the Court of Appeals on the point here at issue; the discussion was dicta, and the decision is not controlling in the case at bar.

In any event, the situation in *CIC* was radically different from that at bar. In *CIC*, the subordination ran in favor of particular, described senior creditors and the motives for subordination were entirely private, having nothing to do with statutory requirements for a regulated business. In the case at bar, Weis and the subordinated lenders knew that the subordination was to meet the statutory requirements for a broker-dealer to continue in business and knew that it was for the protection of the general class of Weis customers who, as long as Weis continued to operate, were becoming general creditors of Weis.

8

There is not only no controlling authority on the point here at issue; there are no decisions on the point.

[1, 2] We must consider, therefore, what equity and fairness would suggest. This seems clearly to be that, as between the customer and other general creditors of Weis on the one hand (for whom the trustee speaks) and the subordinated lenders on the other, the agreements of the latter should be enforced according to their terms in distributing the assets of Weis. As between Weis and the subordinated lenders, the latter are entitled to rescind if fraud is proved; the trustee recognizes this. If the subordinated lenders prove fraud, their claims should be paid before anything is distributed to the stockholders of Weis. But the customer and other general creditors of Weis should be paid before anything is paid to the subordinated lenders.

Every customer and general creditor of Weis knew, or is presumed to have known, that the broker-dealer business of Weis was regulated by federal law and that as part of such regulation the net capital rule was enforced. The subordinated lenders, by their agreements, enabled Weis to comply with the net capital rule and thus to continue in business. The customer and general creditors of Weis should therefore have priority. Under the circumstances, actual reliance is not required to be shown. If the reliance doctrine must be satified as a point of dogma, it should be presumed as a matter of law.

The bank assessment cases seem analogous. Before 1959 (for all practical purposes, before 1933), for many years shareholders of any national bank were by statute personally liable for "all contracts, debts, and engagements" of the bank, to the extent of the par value of their shares; this liability was enforced by assessment. 12 U.S.C. §§ 63, 64.

Cases arose where shareholders defended against an assessment on the ground that their shares were sold by fraud of the bank to them and, since fraud gave them a right of rescission, they were not really to be considered as shareholders. No such defense was allowed because the statutory liability was for the protection of depositors of the bank. It was never suggested that actual reliance on the share ownership or the statutory liability had to be shown.

Such a case was *Scott* v. *Deweese,* 181 U.S. 202, 21 S. Ct. 585, 45 L. Ed. 822 (1901) where (at 213, 21 S. Ct. at 589) it was said:

> "The present suit is primarily in the interest of creditors of the bank. It is based upon a statute designed not only for their protection but to give confidence to all dealing with national banks in respect of their contracts, debts and engagements, as well as to stockholders generally. If the subscriber became a shareholder in consequence of frauds practised upon him by others, whether they be officers of the bank or officers of the Government, he must look to them for such redress as the law authorizes, and is estopped, as against creditors, to deny that he is a shareholder, within the meaning of § 5151, if at the time the rights of creditors accrued he occupied and was accorded the rights appertaining to that position."



A more recent and similar case is *Oppenheimer* v. *Harriman Bank,* 301 U.S. 206, 57 S. Ct. 719, 81 L. Ed. 1042 (1937). Both sides appear to rely on this decision but in my view it supports the position of the trustee. Oppenheimer bought his stock in 1930. The bank closed in 1933 after which Oppenheimer sued for rescission for fraud and eventually secured a money judgment for the amount he had paid for the shares. The Court of Appeals, however, ordered that the judgment be paid only "after payment in full of all who were creditors when the bank became insolvent". This deferment of the judgment was reversed by the Supreme Court which ruled that the judgment was entitled to parity with other unsecured creditors. This ruling was made, however, *because Oppenheimer had already paid the statutory assessment against him.* The significance for the case at bar is the repetition by the Supreme Court of the settled rule that fraud and the ability to rescind are of no avail to defeat protections by statute for a class of creditors. The Supreme Court, citing *Scott* v. *Deweese,* above, with approval, said (301 U.S. at 214, 57 S. Ct. at 724):

> "Plaintiff appeared by the bank's records to be a stockholder and, as against creditors for whose benefit the statutory liability was created, was estopped from denying that status. Recognizing that the bank's fraud and his rescission availed nothing against the comptroller's assessment, plaintiff paid the amount laid against him."

Nothing whatever was said about reliance by creditors on the share ownership or statutory liability.

An even closer analogy is found in an old New York case, *Hurd* v. *Kelly*, 78 N.Y. 588 (1879). A bank was in poor condition. To induce and enable the bank to continue in business Kelly gave the bank a bond, under circumstances strikingly similar to those here. As described in the opinion (at 595):

> "It appears that when the bond was given the assets of the bank had become impaired to an amount as great or greater than the amount of the bond. The bond was executed for the purpose of being exhibited to the bank department as an asset so that the bank might pass the examination and inspection of the department and be enabled to continue its business."

Later the bank failed and a receiver was appointed who sued on the bond. Kelly defended by asserting that he was induced by fraud to sign the bond. This was unanimously held to be no defense, the Court saying (at 596, 597):

> "The intention of the parties was to provide a security in the nature of a guarantee fund of $100,000, to enable the bank to continue its business. It is not claimed that the transaction was *ultra vires*, and if it was, that objection cannot prevail as against the claims of depositors who are represented by the receiver and who is seeking to collect the bond as an asset of the bank, for distribution among those for whose protection it was given. . . .
>
> "The defense that there was a fraudulent concealment by the persons who solicited the defendant to sign the bond, of the true condition of the bank, was, under the circumstances of this case, no answer to the action. It appears from the defendant's answer that he was informed, when he executed the bond, that it was to be used in reference to the relations of the bank to the banking department 'so that a better showing of the apparent assets of the bank would appear.' The defendant was thus apprised that this bond was to be used to give credit to the bank, with the bank department and with the public, so that it should be enabled to continue its business. The fact communicated to him was notice that the bank was in a precarious condition. He knew that if the bond was treated as an asset and the bank thereby allowed to continue its business, new obligations to depositors would be entered into on the faith of the solvency of the institution. Under such circumstances it would be gross injustice to permit the defendant, after having aided the bank to procure credit with the community, to avoid, as against depositors and creditors, the payment of his bond on the allegation that the exact condition of the bank was not disclosed to him, or that it was much worse than was represented. The dealings between him and the officials of the bank, at whose request he signed the bond, ought not, in justice, to be allowed to affect the security given by him for the protection of those dealing with the bank and who must be presumed to have relied thereon in their dealings."



It may be noted that the receiver was not required to show that any depositor in fact knew of Kelly's bond or relied in any way on it. To the contrary, the depositors "must be presumed to have relied thereon in their dealings".

9

[3] Separate consideration should perhaps be given to an additional argument made by the Weis Employees' Profit-Sharing Plan and Trust ("Trust"), one of the subordinated lenders. The Trust argues that its claim should not be subordinated because it falls in, or close to, the category of "wages" given a priority status by Section 64(a)(2) of the Bankruptcy Act (11 U.S.C. § 104(a)(2)). The term "wages" in this section has not been liberally construed but has been

limited to "money directly due [employees] in back wages." *United States* v. *Embassy Restaurant*, 359 U.S. 29, 32, 79 S. Ct. 554, 556, 3 L. Ed. 2d 601 (1959). Contracts in which an employees' trust loans money to the employer at higher than normal interest rates in return for its agreement to subordinate its claim to that of all other creditors scarcely falls within the classic pattern of "back wages".

The order appealed from is reversed and the matter is remanded to the Bankruptcy Judge for further proceedings consistent with this opinion.

SO ORDERED.



UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

In the Matter
—of—
WEIS SECURITIES, INC.,
*Debtor.*

Sol Kittay,
*Plaintiff,*
v.

Edward Redington, Trustee,
*Defendant.*

Claims of George D. Aldrich, *et al.*, Subordinated Lenders.

73 Civ. 2332
Memorandum Opinion

ROY BABITT, *Bankruptcy Judge:*

This dispute between the trustee of the debtor (Weis Securities) and subordinated lenders to the debtor arises out of the debtor's financial demise and its subsequent liquidation under the Securities Investors Protection Act of 1970, 15 U.S.C. §§ 78aaa *et. seq.* (1970 ed.) (SIPA). Proceeding on the assumption that there is no real dispute as to what he perceives to be the controlling and material facts, the trustee has moved for summary judgment, Rule 56, F.R. Civ. P., in his favor, thereby leaving these admitted lenders in the subordinated position, a status for which they contracted.[1]

1. Whether Bankruptcy Rule 756, 411 U.S. 1084, making Rule 56, F.R. Civ. P., applicable, or the latter controls, is not material. Either provides the procedural linchpin for setting the stage for the unfolding of this controversy.

What is central to this case is the effort by the subordinated lenders to retrace the chronology during which they acquired their inferior financial position, come to a different arrangement in this second try and thereby improve their legal position to share in the distribution of the debtor's assets within the scheme of the SIPA. Not surprisingly, the trustee vigorously resists. In short, the subordinated lenders seek rescission of their agreements.

The material facts, at least the historical ones, are not in dispute.

During the period between June 28th, 1967 and May 7, 1973, the subordinated lenders, individually, entered into agreements with the debtor under which loans of cash and/or securities were made to the latter for unrestricted use in its business as a broker-dealer. Each agreement contained express, unequivocal and unambiguous provisions to the effect that in the event of liquidation, the subordinated lender agreed to subordinate his claim for property loaned to the claims of all the other creditors of the debtor and to waive any right to participate in the debtor's assets until the claims of all other creditors were satisfied. Further, each subordinated lender agreed not to permit the withdrawal of his property without the consent of the debtor and the New York Stock Exchange (the Exchange) at any time the debtor was in financial difficulty, including the difficulty in complying with the so-called "Net Capital Rule" under Exchange Rule 325. 17 C.F.R. § 240.15.[2]

The subordination agreements also permitted the broker to freely lend or hypothecate securities loaned without the

2. Some of the subordinated lenders claim to have been customers induced by fraudulent misrepresentations into entering subordination agreements on their cash and stocks held, assertedly in trust, by the debtor.



consent of the particular subordinated lender. Almost all of the securities loaned under the subordination agreement were hypothecated to bank as security for loans prior to the commencement of these liquidation proceedings.

On May 24, 1973, Weis' liquidation was begun in keeping with Section 5(b)(1) of the SIPA, 15 U.S.C. § 78eee(b)(1) (1970 ed.), for the appointment of a trustee to liquidate the debtor's business.

In a complaint for injunctive relief filed on the same day, the Securities and Exchange Commission (S.E.C.) alleged, *inter alia,* that certain of the debtor's financial statements were false and misleading, in violation of the provisions of the Securities Exchange Act of 1934, 15 U.S.C. § 78; (b) and Rule X-10 B-5 promulgated thereunder by the S.E.C. The debtor did not contest the issuance of the injunction.

On or about July 16th, 1974, the subordinated lenders instituted various proceedings against the trustee, the legal effect of all of which would be rescission of the subordination agreements.[3] In their application, the subordinated lenders allege substantially the same facts as those contained in the S.E.C. complaint, *i.e.,* false and misleading financial statements made by the debtor to the subordinated lenders to induce the signing of the subordination agreement in violation of the anti-fraud provisions contained in the Securities Exchange Act of 1934 and Rule 10-b 5.

The trustee, insisting that there are no genuine issues of material fact in dispute, invokes Rule 56 of the Federal Rules of Civil Procedure via Bankruptcy Rule 756, see

3. Some filed complaints seeking to reclaim property, thereby following the adversary proceeding route prescribed by Part VII of the Bankruptcy Rules, 411 U.S. 1068, *et seq.*

footnote 1, *supra,* and seeks judgment, the essence of which would leave the subordinated lenders exactly where their agreements placed them. The trustee's position is that even conceding the truth of what the subordinated lenders urge, they are estopped, as a matter of law, to rescind because of the reliance placed on the subordinations by other creditors who extended credit.

There is case law in support of both arguments, and both come with not unrespectable title deeds. But the controlling case decided in this circuit is *In the Matter of Credit Industrial Corporation,* 366 F. 2d 402 (2d Cir. 1966) where the court held that given a lawful and valid subordination agreement, the bankruptcy court is without equitable power to realign the contractual priorities established by the parties in their contract. 366 F. 2d at 409.

This result is not mandated, however, where the subordination agreement is unlawful, *e.g.,* induced by fraudulent misrepresentation, and therefore invalid. The court explained that

> "When a junior creditor establishes that the subordination agreement is unlawful, it *may* be reasonable and necessary, if equity is to be done, to require a senior creditor to prove that he relied on the subordination agreement, without actual or constructive knowledge of any infirmity in the agreement, in advancing funds to the bankrupt as a condition to receiving priority in the distribution of the bankrupt's estate." [emphasis added]

To this court, applying equitable principles, the law seems to be that should reliance be established, estoppel would bar rescission of the subordination agreement. But the establishment of reliance is surely a factual issue en route to application of legal estoppel. So much seems to be the



import of the language quoted above that "it may be reasonable and necessary" to show reliance.

The trustee insists that proof of reliance would be extraneous in the stock brokerage world where members are subject to the net capital rule. The underlying premise of financial regulation in the securities industry is that the public is entitled to deal with a stockbroker without concern for its financial stability. The Securities and Exchange Commission imposes and monitors compliance with rules concerning financial responsibility for the express benefit of the investing public and confidence in the securities world. It is inevitable that investors will rely on this regulatory scheme and the mere existence of a net capital rule alone should be sufficient proof of justified investor reliance upon the probity of dealing in securities.

The subordinated lenders contend that reliance upon the subordination agreement is not to be assumed. There is no evidence that most of Weis' creditors were aware of the subordination agreements or of the net capital rule. To the extent that customers did rely at all, it may be assumed that such reliance was on the protection provided by the federal laws regulating the industry. Indeed, if anything, the SIPA offered greater security in dealings between customers and the debtor-broker.

The net capital rule insures liquidity against current customer demands, not security against broker-dealer insolvency. See *Study of Unsafe and Unsound Practices,* CCH Fed. Sec. L. Rep. Special Studies 74, 801 at 65, 521. The very purpose behind the SIPA was to provide the kind of protection against broker-dealer insolvency which the net capital rule was unable to achieve. Finally, the subordinated lenders contend that it is probable that institutional investors and other large creditors of the debtor were misled

into extending credit on the basis of the very same fraudulent financial statements overstating Weis' net worth that misled these litigants into signing the subordination agreements. But the trustee has no right to assert estoppel. Those dealing with the debtor relied primarily on the false financial statements, not the security provided by the net capital rule.

It seems to this court that reliance must be shown and that summary judgment is not appropriate.

> ". .. summary judgment is a drastic device to be applied only when there are no material factual issues to be tried. In making that determination, the court 'must resolve all ambiguities and draw all reasonable inferences in favor of the party against whom summary judgment is sought . . . with the burden on the moving party to demonstrate the absence of any material factual issue genuinely in dispute'. *Heyman* v. *Commerce and Industry Insurance Co.*, 524 F. 2d 1317, 1320 (2d Cir. 1975); *Judge* v. *City of Buffalo*, 524 F. 2d 1321 2d Cir. 1975)". *Gladstone* v. *Fireman's Fund Insurance Co.*, —— F. 2d —— (2d Cir. May 17, 1976; Docket No. 75-7435).

The issue of reliance is a material one essential to determining whether the court will impose promissory estoppel on the subordinated lenders. In light of the issue raised as to whether there was, in fact, reliance, summary judgment should not preclude a showing; resolution of this factual issue is necessary.

The trustee presses another ground to support summary judgment in his favor. He claims that the subordination agreement was made not only between his adversaries here and the debtor, but also between the former and the Exchange. Thus, the trustee goes on, the Exchange has separate contract rights in the subordination agreements independent of those possessed by the debtor's trustee. But any



rights the Exchange might have are not affected by the debtor's alleged misrepresentations. *Insurance Co. of North America* v. *Brehm*, 257 Ore. 385, 393-394, 478 P. 2d 387, 391 (1971); *Peoples Trust Co.* v. *O'Neil*, 273 N.Y. 312, 316, 7 N.E. 2d 244, 246 (1937). The debtor's creditors and customers are clearly the third party beneficiaries of the agreements with the Exchange and could themselves sue the subordinated lenders for specific performance of open promises. *Pond* v. *New Rochelle Water Co.*, 183 N.Y. 330, 76 N.E. 211 (1906). Accordingly, the trustee could sue on the subordinated lenders' promises by his title to causes of action under Section 70a of the Act, 11 U.S.C. § 110a. The subordinated lenders vigorously and correctly disagree with the trustee's stand on this. There is no evidence of any contractual agreement between the subordinated lenders and the Exchange. The New York Stock Exchange was not a party to the Senior Subordinated Note Agreement which the lenders and the debtor executed on September 29; indeed, the Exchange was in no way involved in the dealings between the lenders and the debtor. Nor did the lenders enter into separate agreement with the Exchange to subordinate their rights. The fact that the transactions between the debtor and the lenders required Exchange approval does not make the Exchange a party to the transaction. Absent evidence of a subordination agreement with the Exchange, the trustee's theory falls.

The court therefore denies trustee's motion for summary judgment as an evidentiary hearing is needed in respect of the following material issues of fact: did the general creditors rely upon the subordination agreement or the net capital rule when they invested in or extended credit to the debtor; is there conclusive proof that the subordinated lenders entered into a separate subordination agreement with the New York Stock Exchange. If either of the above

two questions results in an affirmative finding the trustee will be entitled to judgment. If reliance is proven, the subordinated lenders will be estopped from rescinding the agreement for fraud. *In the Matter of Credit Industrial Corporation, supra,* at 409. If an independent contract between claimant and the New York Stock Exchange is substantiated, that contract will remain in force regardless of any fraud perpetrated by Weis. *Insurance Co. of North America* v. *Brehm, supra,* at 392, 390.

If neither of the above questions is answered by an affirmative finding, it will become necessary to determine whether the debtor fraudulently misrepresented financial information of sufficient materiality to support rescission of the subordination agreement. In short, the court concludes that there is a two step inquiry which must be had and upon which findings must be made following trial. The second is reached only if the first is found in favor of the lenders.

Accordingly, summary judgment is refused by reason of the existence of material facts as to which the court is unable to make findings for want of probative evidence. Trial will be had on these issues following recourse to the discovery procedures carried in the Federal Rules of Civil Procedure and the Bankruptcy Rules incorporating the former. Upon conclusion of all discovery, the court will fix a trial date after a pre-trial conference with counsel to be arranged on five days notice. Submit order.

DATED: New York, New York.

July 15, 1976

ROY BABITT,
Bankruptcy Judge.



*FEDERAL STATUTES*

**Securities Act of 1933***

**15 U.S.C. § 77p**

**Additional remedies**

The rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.

**15 U.S.C. § 77r**

**State control of securities**

Nothing in this subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person.

**Securities Exchange Act of 1934**

**15 U.S.C. § 78f**

**Registration of national securities exchanges**

(a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder;

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* Provisions of the Securities Acts are set forth as they were in effect prior to the Securities Acts Amendments of 1975, Pub L. No. 94-29, 89 Stat. 97 (June 4, 1975).

(2) Such data as to its organization, rules or procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the "rules of the exchange"; and

(4) An agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willfull violation of any provisions of this chapter or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

(c) Nothing in this chapter shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this chapter and the rules and regulations thereunder and the applicable laws of the State in which it is located.

(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this chapter and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

(e) Within thirty days after the filing of the application, the Commission shall enter an order either granting or, after appropriate notice and opportunity for hearing, denying registration as a national securities exchange, unless the exchange applying for registration shall withdraw its application or consent to the Commission's deferring action on its application for a stated longer period after the date of filing. The filing with the Commission of an application for registration by an exchange shall be deemed to have taken place upon the receipt thereof. Amendments to an application may be made upon such terms as the Commission may prescribe.



(f) An exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary for the protection of investors, withdraw its registration.

**Securities Investor Protection Act of 1970**

**15 U.S.C. § 78bbb**

**Application of securities exchange act of 1934**

Except as otherwise provided in this Act, the provisions of the Securities Exchange Act of 1934 (15 U.S.C., sec. 78a and fol.; hereinafter referred to as the "1934 Act") apply as if this Act constituted an amendment to, and was included as a section of, such Act.

**15 U.S.C. § 78ccc**

**Securities investor protection corporation**

**(a) Creation.**—There is hereby established a body corporate to be known as "Securities Investor Protection Corporation" (hereafter in this Act referred to as "SIPC"). SIPC shall be a nonprofit corporation and shall have succession until dissolved by act of the Congress. SIPC shall—

(1) not be an agency or establishment of the United States Government;

(2) be a membership corporation the members of which shall be—

(A) All persons registered as brokers or dealers under section 15(b) of the 1934 Act, and

(B) all persons who are members of a national securities exchange,

* * * *

**15 U.S.C. § 78ddd**

**SIPC Fund**

**(a) In General.—**

**(1) Establishment of fund.**—SIPC shall establish a "SIPC Fund" (hereinafter in this Act referred to as the "fund"). All amounts received by SIPC (other than amounts paid directly to any lender pursuant to any pledge securing a borrowing by SIPC) shall be deposited in the fund, and all expenditures made by SIPC shall be made out of the fund.

* * * *

**(c) Assessments.—**

**(1) Initial assessments.**—Each member of SIPC shall pay to SIPC, or the collection agent for SIPC specified in section 9(a), on or before the one hundred and twentieth day following the date of enactment of this Act, an assessment equal to one-eighth of 1 per centum of the gross revenues from the securities business of such member during the calendar year 1969, or if the Commission shall determine that, for purposes of assessment pursuant to this paragraph, a lesser percentage of gross revenues from the securities business is appropriate for any class or classes of members (taking into account relevant factors, including but not limited to types of business done and nature of securities sold), such lesser percentages as the Commission, by rule or regulation, shall establish for such class or classes, but in no even less than one-sixteenth of 1 per centum for any such class. In no event shall any assessment upon a member pursuant to this paragraph be less than $150.

**(2) General assessment authority.**—SIPC shall, by bylaw or rule, impose upon its members such assessments as, after consultation with self-regulatory organizations, SIPC may deem necessary and appropriate to establish and maintain the fund and to repay any borrowings by SIPC. Any assessments so made shall be in conformity with contractual obligations made by SIPC in connection with any borrowing incurred by SIPC. Subject to paragraph (3) and subsection (d)(1)(A), any such assessment upon the members, or any one or more classes thereof, may, in whole or in part, be based upon or measured by (A) the amount of their gross revenues from the securities business, or (B) all or any of the following factors: the amount or composition of their gross revenues from the securities business, the number or dollar volume of transactions effected by them, the number of customer accounts maintained by them or the amounts of cash and securities in such accounts, their net capital, the nature of their activities (whether in the securities business or otherwise) and the consequent risks, or other relevant factors.



* * * *

**(g) SEC Loans to SIPC.**—In the event that the fund is or may reasonably appear to be insufficient for the purposes of this Act, the Commission is authorized to make loans to SIPC. At the time of application for, and as a condition to, any such loan, SIPC shall file with the Commission a statement with repect to the anticipated use of the proceeds of the loan. If the Commission determines that such loan is necessary for the protection of customers of brokers or dealers and the maintenance of confidence in the United States securities markets and that SIPC has submitted a plan which provides as reasonable an assurance of prompt repayment as may be feasible under the circumstances, then the Commission shall so certify to the Secretary of the Treasury, and issue notes or other obligations to the Secretary of the Treasury pursuant to subsection (h) . . .

**(h) SEC Notes Issued to Treasury.**—To enable the Commission to make loans under subsection (g), the Commission is authorized to issue to the Secretary of the Treasury notes or other obligations in an aggregate amount of not to exceed $1,000,000,000, in such forms and denominations, bearing such maturities, and subject to such terms and conditions, as may be prescribed by the Secretary of the Treasury. Such notes or other obligations shall bear interest at a rate determined by the Secretary of the Treasury, taking into consideration the current average market yield on outstanding marketable obligations of the United States of comparable maturities during the month preceding the issuance of the notes or other obligations. The Secretary of the Treasury may reduce the interest rate if he determines such reduction to be in the national interest. The Secretary of the Treasury is authorized and directed to purchase any notes and other obligations issued hereunder and for that purpose he is authorized to use as a public debt transaction the proceeds from the sale of any securities issued under the Second Liberty Bond Act, as amended, and the purposes for which securities may be issued under that Act, as amended, are extended to include any purchase of such notes and obligations. The Secretary of the Treasury may at any time sell any of the notes or other obligations acquired by him under this subsection. All redemptions, purchases, and sales by the Secretary of the Treasury of such notes or other obligations shall be treated as public debt transactions of the United States.

**15 U.S.C. § 78fff**

**Liquidation proceedings**

**(a) General Purposes of Liquidation Proceeding.**—The purposes of any proceeding in which a trustee has been appointed under section 5(b) (3) (hereafter in this section referred to as a "liquidation proceeding") shall be:



(1) as promptly as possible after such appointment and in accordance with the provisions of this sections—

(A) to return specifically identifiable property to the customers of the debtor entitled thereto;

(B) to distribute the single and separate fund, and (in advance thereof or concurrently therewith) pay to customers moneys advanced by SIPC, as provided in subsection (f);

(2) to operate the business of the debtor in order to complete open contractual commitments of the debtor pursuant to subsection (d);

(3) to enforce rights of subrogation as provided in this Act; and

(4) to liquidate the business of the debtor.

* * * *

**(c) Application of Bankruptcy Act.—**

* * * *

**(2) Special Provisions.**—The following subparagraphs of this paragraph shall apply to a liquidation proceeding in lieu of section 60e of the Bankruptcy Act:

**(A) Definitions.**—Except as otherwise expressly provided in this section, for purposes of this section and the application of the Bankruptcy Act to a liquidation proceeding—

(i) "property" includes cash and securities, whether or not negotiable and all property of a similar character;

(ii) "customers" of a debtor means persons (including persons with whom the debtor deals as principal or agent) who have claims on account of securities received, acquired, or held by the debtor from or for the account of such

persons (I) for safekeeping, or (II) with a view to sale, or (III) to cover consummated sales, or (IV) pursuant to purchases, or (V) as collateral security, or (VI) by way of loans of securities by such persons to the debtor, and shall include persons who have claims against the debtor arising out of sales or conversions of such securities, and shall include any person who has deposited cash with the debtor for the purpose of purchasing securities, but shall not include any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor;

(iii) "cash customer" means, with respect to any securities or cash, customers entitled to immediate possession of such securities or cash without the payment of any sum to the debtor, and for purposes of this clause, the same person may be a cash customer with reference to certain securities or cash and not a cash customer with reference to other securities or cash;

* * * *

**(f) SIPC Advances to Trustee.—**

**(1) Advances for customers' claims.**—In order to provide for prompt payment and satisfaction of the net equities of customers of debtor, SIPC shall advance to the trustee such moneys as may be required to pay or otherwise satisfy claims in full of each customer, but not to exceed $50,000 for such customer; except that—

(A) insofar as all or any portion of the net equity of a customer is a claim for cash, as distinct from securities, the amount advanced by reason of such claim to cash shall not exceed $20,000;



(B) a customer who holds accounts with the debtor in separate capacities shall be deemed to be a different customer in each capacity;

(C) no such advance shall be made by SIPC to the trustee to pay or otherwise satisfy, directly or indirectly, any claims of any customer who is a general partner, officer, or director of the debtor, the beneficial owner of 5 per centum or more of any class of equity security of the debtor (other than a nonconvertible stock having fixed preferential dividend and liquidation rights) or limited partner with a participation of 5 per centum or more in the net assets or net profits of the debtor; and

(D) no such advance shall be made by SIPC to the trustee to pay or otherwise satisfy claims of any customer who is a broker or dealer or bank other than to the extent that it shall be established to the satisfaction of the trustee, from the books and records of the debtor or from the books and records of a broker or dealer or bank or otherwise, that claims of such broker or dealer or bank against the debtor arise out of transactions for customers of such broker or dealer or bank, in which event, each such customer of such broker or dealer or bank shall be deemed a separate customer of the debtor.

To the extent that moneys are advanced by SIPC to the trustee to pay the claims of customers, SIPC shall be subrogated to the claims of such customers with the rights and priorities provided in this section.

* * * *

**15 U.S.C. § 78iii**

**Functions of self-regulatory organizations.**

**(a) Colletcing Agent.**—Each self-regulatory organization shall act as collection agent for SIPC to collect the assessments payable by all members of SIPC for

whom such self-regulatory organization is the examining authority, and members of SIPC who are not members of any self-regulatory organization shall make payment direct to SIPC. An examining authority shall be obligated to remit to SIPC assessments made under section 4 only to the extent that payments of such assessments are received by such examining authority.

*RULES OF THE NEW YORK STOCK EXCHANGE*

**Rule 325.**

"(a) No member or member organization doing any business with others than members or member organizations or doing a general business with the public, except a member or member organization subject to supervision by State or Federal banking authorities, shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtedness to exceed 1500 per centum of his or its Net Capital, which Net Capital shall be not less than $100,000 in the case of a member organization which carries any accounts for customers. . . .

"(b) For the purpose of this rule—

"(1) The term 'proprietary accounts' shall include capital accounts of partners or sole proprietor, investment and trading accounts, participations in joint accounts, accounts of partners which are covered by agreements, approved by the Exchange, providing for the inclusion of equities therein as partnership property and borrowings covered by subordination agreements approved by the Exchange;

"(2) the term 'Aggregate Indebtedness' shall include the total money liabilities of the member or member organization in all accounts other than customers' and brokers' accounts for commodity future contracts; plus equities in customers' and brokers' accounts for commodity future contracts; plus the market value of securities borrowed (other than for delivery against



customers' sales) for which no equivalent value is paid or credited, exclusive of the following:

"(A) money borrowed (adequately collateralized) on securities, spot commodities or other assets owned by the member, member firm or general partner thereof, or a member corporation and on those subordinated to general creditors;

"(B) money payable against securities loaned which are owned by the member, member firm or general partner thereof, or a member corporation and those subordinated to general creditors;

"(C) money payable against securities failed to receive in connection with transactions for the account of the member, member firm or general partner thereof, or a member corporation and for accounts subordinated to general creditors;

"(D) money borrowings adequately collateralized by securities exempted from registration under the Securities and Exchange Act of 1934, otherwise than by action of the Securities and Exchange Commission;

"(E) liabiilties subordinated to general creditors pursuant to a separate agreement approved by the Exchange;

"(3) The term 'Net Worth' shall be the excess of total assets over total liabilities, after provision for current dividends declared and unpaid by a member corporation (except that credit balances and equities in 'proprietary accounts' shall not be considered as liabilities) with securities, spot commodities, commodity future contracts in 'proprietary accounts' and all other assets marked to market or fair value. A loss, at market, in an individual contractual commitment shall be deducted in determining Net Worth and a profit shall not be included. (See (c)(10) 'Special Provisions' below.)

"(4) the term 'Net Capital' shall be Net Worth, less the following:

*Debit Items*

"(A) Amounts included in Net Worth for:

"(i) Memberships, furniture and fixtures, real estate and other fixed assets;

"(ii) the value of securities which have no ready market or the sale of which is inhibited by a statutory, regulatory or contractual provision;

". . ."

**Rule 325.20**

"*Subordinated borrowings by member organizations evidenced by non-transferable instruments.*—All subordinated borrowings by a member organization evidenced by instruments which are not transferable without the prior consent of the Exchange, where the proceeds, whether of cash or securities, or both, are to be considered in the computation of Net Capital under Rule 325, must receive prior approval of the Exchange. Such borrowings may be arranged with anyone acceptable to the Board of Governors and are subject to the following provisions:

"(1) Subordinated borrowings of cash

"(A) The lender may be paid interest not to exceed the rate set from time to time by the Exchange.

"(B) If the lender is

"(i) a member of the family of one of the borrowing organization's general partners or holders of voting stock, or of a deceased general partner or holder of voting stock;

"(ii) an estate of or trust established by or for one of the borrowing organization's general partners or holders of voting stock;

"(iii) one of the borrowing organization's employees or the employee pension, retirement or profit-sharing plan of the borrowing organization; or

"(iv) a limited partner or holder of non-voting stock of the borrowing organization he may also share in organization profits to a reasonable extent.



"(2) Subordinated borrowings of securities

"(A) If the lender is a person listed in (1)(B) above, he may be paid interest not to exceed the rate set from time to time by the Exchange. He may also share in organization profits to a reasonable extent.

"(B) If the lender is anyone other than those listed in (1)(B) above

"(i) the number of such borrowings by a member organization shall be reasonable in relation to the size of the organization, and the total dollar amount of such borrowings shall not constitute more than 25% of the total capital of the borrowing organization.

"(ii) compensation for the loan or subordination of the account shall not exceed the rate set from time to time by the Exchange.

"(3) Application of the borrowing member organization shall be filed with the Exchange together with application signed by the lender, in form prescribed by the Exchange, which shall contain the following:

"(A) name of the lender; (identify the relationship of the lender to the organization or one of its general partners or holders of voting stock);

"(B) signed copy of the subordination agreement in form prescribed by the Exchange;

"(C) opinion of counsel to the borrowing organization stating that the subordination agreement is binding and enforceable in accordance with its terms upon the lender and his creditors;

"(D) check of the applying member organization for $100 covering Exchange fee for consideration of the application. While the fee is payable at the time of posting, a member organization may request that the charge be placed on the regular quarterly statement from the Exchange;

"(5) Borrowings must be made pursuant to printed standard forms prescribed as permitted by the Exchange, to increase and in no event to decrease the permanence of the capital funds. These forms provide, among other things:

"(A) That cash may be contributed to a member organization by means of a cash subordinated loan agreement or a subordinated debenture, with a maturity date at least one year from the date of the subordinated loan or debenture, and with acceleration provisions, if any, which may be exercised on not less than six months' written notice given no sooner than six months from the date of the subordinated loan or debenture, provided that if, after giving effect to payment at maturity date or any accelerated maturity date, the Aggregate Indebtedness of the member organization would exceed 1200 per centum of its Net Capital, or its Net Capital would fail to equal or exceed the minimum dollar amount required by Rule 325(a), the obligation of the member organization to repay the subordinated loan or debenture would be postponed until, after giving effect to such payment, the Aggregate Indebtedness of the member organization would not exceed 1200 per centum of its Net Capital or its Net Capital would equal or exceed the minimum dollar amount required by Rule 325(a). The amount of a subordinated loan or debenture may be decreased or the principal may be paid off with the prior written approval of the Exchange. Each member organization shall promptly notify the Exchange of the receipt of any notice of accelerated maturity of any subordinated loan or debenture or if the payment of any subordinated debt is not made because, after giving effect to such payment, the Aggregate Indebtedness of the member organization would exceed 1200 per centum of its Net Capital or its Net Capital would fail to equal or exceed the minimum dollar amount required by Rule 325(a).

"(B) That securities which are fully paid for may be contributed to a member organization as collateral for a secured demand note, pursuant to a secured demand note collateral agreement which provides that if at any time the capital requirements value of the collateral is less than the then unpaid balance of the secured demand note the member organization shall notify the lender. Following such notification, the lender may (i) with the prior consent of the Exchange reduce the principal amount of the secured demand note by not more than 15%, provided the member organization clearly establishes that the Aggregate Indebtedness of the member organization would not exceed 1000% of its Net Capital after giving effect to such reduction, and further provided that in the event of such reduction the right of the lender to withdraw collateral shall be suspended, or (ii) contribute additional collateral sufficient to bring the value for Net Capital purposes of the collateral up to the then unpaid balance of the secured note. Unless the unpaid principal amount of the note is reduced or such additional collateral is so pledged, the collateral securing the note shall be sold on the business day next succeeding the giving of such notice. Wtihout the prior written approval of the Exchange, the secured demand note may not be withdrawn prior to the withdrawal date fixed in the collateral agreement, which date must be at least one year but not more than ten years from the date of the collateral agreement, provided, however, that the contributor may accelerate the withdrawal date by giving not less than six months written notice to the organization and to the Exchange delivered no sooner than six months from the date of the collateral agreement. At any time, if after giving effect to a proposed withdrawal, the Aggregate Indebtedness of the member organization would exceed 1200 per centum of its Net Capital or its Net Capital would fail to meet the minimum dollar amount required by Rule 325(a), the member organization's obligation to return the secured demand note and the collateral shall be suspended. Each member organization shall promptly notify the Exchange of the receipt of any notice of accelerated maturity of any secured demand note or if any withdrawal of subordinated debt is not made because, after giving effect to such withdrawal, the Aggregate Indebtedness of the member

organization would exceed 1200 per centum of its Net Capital or its Net Capital would fail to meet the minimum dollar amount required by Rule 325(a).

"(C) That with the prior approval of the Exchange cash or securities (including equities in margin accounts) may be contributed to a member organization by its members, allied members, limited partners or holders of non-voting common stock as temporary capital for the purpose of adding to its Net Capital in connection with unusual underwritings. Such temporary infusions may not be made on more than three occasions in any twelve month period. If in the form of cash, the temporary subordinated loan would be evidenced by a temporary cash subordination agreement or a temporary subordinated debenture, and if in the form of securities by a secured demand note and a temporary secured demand note collateral agreement. The debenture or the collateral agreement shall bear a maturity date of 45 days from the date thereof and may not be repaid at any time, if after giving effect to such repayment, the Aggregate Indebtedness of the member organization would exceed 1000 per centum of its Net Capital or its Net Capital should be less than the minimum dollar amount required by Rule 325(a). Neither agreement would contain any provisions for acceleration of the maturity date and a contributor pursuant to a temporary secured demand note collateral agreement would not have an option to reduce the principal amount of an undercollateralized note, but in almost every other respect, the temporary capital agreements would resemble the agreements described in A and B.

"(5) Each member organization which has subordinated debt or equity capital scheduled for withdrawal shall take whatever measures are necessary to replace the capital scheduled for withdrawal or to reduce its capital needs commensurate with the amount of capital remaining after withdrawal. Failure of the member organization to take such measures in a timely manner



will result in corrective action being required by the Exchange under Rule 326.

"(6) A statement of a proposed lender for approval to make a subordinated loan to a member organization is ordinarily not acted upon by the Board of Governors until after notice of the proposal has been posted on the Bulletin Board of the Exchange for a period of two weeks. Such notice is posted upon submission, in proper form, of all required papers in connection with the proposal."

**Rule 405.** Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) [¶ 2342] to:

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

**Supervision of Accounts**

(2) Supervise diligently all accounts handled by registered representatives of the organization.

**Approval of Accounts**

(3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) [¶ 2342]. The member, general partner, officer or designated person approving the opening of the account shall, prior to giving his ap-

proval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization.

**Common Sales Accounts**

(4) To facilitate the isolated liquidation of securities valued at $1,000 or less registered in the name of an individual who does not have an account, and which are not part of any distribution, a member organization may sell the securities through a common sales account set up for the specific purpose of handling such sales without sending a periodic statement to the customer as required by Rule 409, provided:

a) The customer is identified as the individual in whose name the securities are registered,

b) The securities are received by the member, at or prior to the time of the entry of the order, in the exact amount to be sold in good delivery form,

c) A confirmation is sent to each customer,

d) All proceeds of such sales are paid out on or immediately following settlement date, and

e) The record made in the common sales account includes as to each transaction: customer's name address, name and amount of securities to be sold, date received, date sold, amount per share, total amount credited to the account, total amount of check issued to the customer and the date of disbursement.

*ILLINOIS STATUTES*

**Ill. Rev. Stat. (1977) ch. 121½ § 137.12**

**Violation.** It shall be a violation of the provisions of this Act for any person:

A. To sell any security except in accordance with the provisions of this Act;



B. To deliver to a purchaser any security required to be registered under Section 5, Section 6 or Section 7 hereof unless accompanied or preceded by a prospectus that meets the requirements of the pertinent subsection of Section 5 or of Section 6 or of Section 7;

C. To act as a dealer, salesman or investment adviser unless registered as such, where such registration is required, under the provisions of this Act;

D. To fail to file with the Secretary of State any application, report or document required to be filed under the provisions of this Act or any rule or regulation made by the Secretary of State pursuant to this Act or to fail to comply with the terms of any order of the Secretary of State issued pursuant to Section 11 hereof;

E. To make, or cause to be made, (1) in any application, report or document filed under this Act or any rule or regulation made by the Secretary of State pursuant to this Act, any statement which was false or misleading with respect to any material fact or (2) any statement to the effect that a security (other than a security issued by the State of Illinois) has been in any way endorsed or approved by the Secretary of State or the State of Illinois;

F. To engage in any transaction, practice or course of business in connection with the sale or purchase of securities which works or tends to work a fraud or deceit upon the purchaser or seller thereof;

G. To obtain money or property through the sale of securities by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading;

H. To sign or circulate any statement, prospectus, or other paper or document required by any provision of this Act knowing or having reasonable grounds to know any material representation therein contained to be false or untrue;

I. To employ any device, scheme or artifice to defraud in connection with the sale or purchase of any security, directly or indirectly.

J. When acting as an investment adviser, by any means or instrumentality, directly or indirectly:

(1) To employ any device, scheme or artifice to defraud any client or prospective client;

(2) To engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) To engage in any act, practice, or course of business which is fraudulent, deceptive or manipulative. The Secretary of State shall for the purposes of this Paragraph (3) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative.
Amended by P.A. 76-1083, § 1, eff. Jan. 1, 1970.

**Ill. Rev. Stat. (1977) ch. 121½, § 262**

**Unlawful practices—Construction with Federal Trade Commission Act.]** Unfair methods of competition and unfair or deceptive acts or practices, including but not limited to the use or employment of any deception, fraud, false pretense, false promise, misrepresentation or the concealment, suppression or omission of any material fact, with intent that others rely upon the concealment, suppression or omission of such material fact, or the use or employment of any practice described in Section 2 of the "Uniform Deceptive Trade Practices Act", approved August 5, 1965, in the conduct of any trade or commerce are hereby declared unlawful whether any person has in fact been mislead, deceived or damaged thereby. In construing this section consideration shall be given to the interpretations of the Federal Trade Commission and the federal courts relating to Section 5(a) of the Federal Trade Commission Act.

Amended by P.A. 78-904, § 1, eff. Oct. 1, 1973.



**Ill. Rev. Stat. (1971) ch. 121½ § 262**

**Unlawful practice.]** The act, use or employment by any person of any deception, fraud, false pretense, false promise, misrepresentation, or the concealment, suppression, or omission of any material fact with intent that others rely upon such concealment, suppression or omission, in connection with the sale or advertisement of any merchandise, whether or not any person has in fact been misled, deceived or damaged thereby, is declared to be an unlawful practice; provided, however, that nothing herein contained shall apply to the owner or publisher of newspapers, magazines, publications or printed matter wherein such advertisement apepars, or to the owner or operator of a radio or television station which disseminates such advertisement when the owner, publisher or operator has no knowledge of the intent, design or purpose of the advertiser; and provided, further, that nothing herein contained shall apply to any advertisement which is subject to and complies with the rules and regulations of, and the statutes administered by the Federal Trade Commission.

Ammended by P.A. 76—1061, § 1, eff. Aug. 28, 1969.
Added by L. 1965, p. 835.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

| | |
|---|---|
| IN the Matter of WEIS SECURITIES, INC., *Debtor.* | 73 Civ. 2332 Petition on Behalf of Eva Grossmann |

NOW COME THE PEOPLE OF THE STATE OF ILLINOIS ex rel. WILLIAM J. SCOTT, the Attorney General of the State of Illinois, and, in behalf of EVA GROSSMANN, a citizen and resident of the State of Illinois, repectfully petition this Honorable Court as follows:

1. EVA GROSSMANN is a citizen and resident of the State of Illinois. She is a foreign born widow. After having spent the greater part of the war years during the Second World War as a slave laborer in German concentration camps, she came to this country in 1947. From that time on she worked, with the exception of a short intermission, continuously as a fitter for Chas. A. Stevens Co. in Chicago, Illinois, where she is still employed.

2. In 1967, after her husband's death, she was induced by the husband of one of the store's customers, at which she was working, to put all her savings in subordinate debentures of Weis, Voisin, Cannon, Inc. The man who induced her to place her savings in those subordinate debentures was Leo Meiselman, Executive Vice President of Weis, Voisin, Cannon, Inc.



3. In accordance with the aforementioned inducement, a debenture was issued to Mrs. Grossmann by Weis, Voisin and Cannon, in the amount of 15,000.00 on the 28th of June, 1967, denominated as a two year Debenture Bond. A copy of a letter of Weis, Voisin, Cannon, Inc., dated June 29, 1967, as well as a copy of the bond are herewith attached to this Petition as Exhibit A and B, respectively, and made a part hereof. In a letter, dated July 2, 1969, addressed to Mrs. Grossmann, Weis, Voisin, Cannon, Inc. acknowledged receipt from Mrs. Grossmann of a check in the amount of $5,000.00 for Mrs. Grossmann's Debenture Account; a copy of that letter is attached to this Petition as Exhibit C. No Debenture Bond for the amount of $5,000.00 was ever delivered to Mrs. Grossmann.

4. The debenture bonds in the amount of $20,000.00 were automatically renewed by Weis, Voisin, Cannon, Inc. without ever having asked Mrs. Grossmann for her approval. See copy of letter of Weis, Voisin, Cannon, Inc. dated June 18, 1969, herewith attached hereto as Exhibit D.

5. By letter dated April 27, 1973, Weis Securities, Inc. requested Mrs. Grossmann to confirm her account of Subordinated Debentures in the sum of $20,000.00. A copy of that letter is herewith attached to this Petition as Exhibit E.

6. At no time did Weis, Voisin, Cannon, Inc. or any of its representatives inform Mrs. Grossmann of the fact that the debentures issued to her were unsecured and subordinated to the claims of other creditors, nor did Mrs. Grossmann have the educational background or the financial capability or sophistication to understand or grasp the import and significance of a subordinated-unsecured debenture.

7. At no time was any notice or information furnished to Mrs. Grossmann that Weis, Voisin, Cannon, Inc. had transferred its business to Weis Securities. Failure to give such information was in clear violation of the Illinois Bulk Sales Act.

8. The failure of Weis, Voisin, Cannon, Inc. to fully inform and advise Mrs. Grossmann regarding the nature of the securities sold to her was not only in violation of the Illinois Securities Act (Ill. Rev. Stat. 1973, ch. 121-½, sec. 137.12(F), (G), and (I)), and the pertinent provisions of the Federal Securities and Exchange Act but also amounted to gross fraud and the breach of a fiduciary duty owed by the broker to the customer.

9. Weis, Voisin, Cannon, Inc. and Weis Securities, Inc., having committed such fraud and having acted in contravention of the applicable statutes as well as having been guilty of a gross breach of their fiduciary duties, the amount of $20,000.00 paid by Mrs. Grossmann was unlawfully received and held under a constructive trust by Weis, Voisin, Cannon, Inc. and Weis Securities for the benefit of claimant, EVA GROSSMANN.

10. The claim of EVA GROSSMANN in the amount of $20,000.00 was allowed in full by the Trustee as a claim subordinate to the claims of creditors of the Debtor.

WHEREFORE, it is respectfully petitioned that this Court order that the amount of TWENTY THOUSAND DOLLARS ($20,000.00) is held by the Trustee for the liquidation of the business of Weis Securities, Inc., under a con-



structive trust for the benefit of the claimant, EVA GROSSMANN, and that said amount be segregated from the estate in liquidation and paid out in full to claimant, EVA GROSSMANN.

Respectfully submitted,

WILLIAM J. SCOTT,
Attorney General of the
State of Illinois.

By: FRED F. HERZOG,
160 North LaSalle Street,
Suite 900,
Chicago, Illinois 60601,
(793-3500).

FRED F. HERZOG,
First Assistant Attorney General,
160 North LaSalle Street, Suite 800,
Chicago, Illinois 60601 (793-2457),
*Of Counsel.*

WEIS, VOISIN, CANNON, INC.
ESTABLISHED 1927
MEMBERS NEW YORK AND AMERICAN STOCK EXCHANGES
AND PRINCIPAL COMMODITY EXCHANGES
141 W. JACKSON BOULEVARD • CHICAGO, ILL. 60604
WABASH 2-5100

MAIN OFFICE
111 BROADWAY
NEW YORK, N. Y. 10006
WORTH 4-7300

BRANCH OFFICES
63RD ST. & 2ND AVE., N. Y. C.
CEDARHURST, L. I., N. Y.
CHICAGO, ILLINOIS
NEW HAVEN, CONN.
ENGLEWOOD, N. J.
MAPLEWOOD, N. J.
MIAMI BEACH, FLA.

June 29, 1967

**EXHIBIT A**

Mrs. Eva Grossman
1050 West Catalpa
Chicago, Illinois 60640

Dear Mrs. Grossman:

We acknowledge receipt of:

Cashier check #099881 drawn on the Chicago Federal Savings and Loan Association payable to Weis, Voisin, Cannon, Inc. in the amount of $7,000.00, and

Cashier check #SO417669 drawn on the Uptown Federal Savings and Loan Association payable to Weis, Voisin, Cannon, Inc. in the amount of $8,000.00.

These funds are to be used to purchase two-year debentures with ninety day notice from our firm, Weis, Voisin, Cannon, Inc.

Thank you for your cooperation, I am,

Respectfully,

WEIS, VOISIN, CANNON, INC.
S/ Leo Meiselman,
Leo Meiselman,
Executive Vice President

LM:mek
Encl.

No. 31 $ 15,000

# WEIS, VOISIN, CANNON, INC.

INCORPORATED UNDER THE LAWS OF THE STATE OF DELAWARE

NAME OF REGISTERED OWNER Mrs. Eva Grossmann

WEIS, VOISIN, CANNON, INC., a corporation duly organized and existing under and by virtue of the laws of the State of Delaware, and duly authorized to conduct business in the State of New York (hereinafter called "Corporation") being a member of the New York Stock Exchange, the American Stock Exchange and other principal commodity exchanges, with its principal office at 111 Broadway, New York, N. Y., hereby promises to pay to the registered holder hereof (unless this debenture shall have been duly called for previous redemption and payment) upon presentation hereof on the 1st day of July, 1969, in legal tender of the United States of America, the principal sum of * * * * * * FIFTEEN THOUSAND * * * * * DOLLARS ($ 15,000.00 )

Payments of principal as well as interest, are to be made at the Main Office of the Corporation. Interest on the remaining unpaid balance of principal shall become due at the rate of 8 per cent per annum from the date hereof, such interest being payable quarter-annually on the first day of April, July, October and January of each month in each and every such month following the date hereof.

The registered holder by acceptance of this subordinated debenture agrees for himself, his heirs, executors, administrators and assigns that the obligations of the Corporation under this agreement with respect to the payment of principal and interest are and shall be subordinate in right of payment and subject to the prior payment or provision for payment in full of all claims of all other present and future creditors of the Corporation arising out of any matter occurring prior to the Installment Date, and that, in the event of any receivership, insolvency, bankruptcy, assignment for the benefit of creditors, reorganization, whether or not pursuant to bankruptcy laws, liquidation, or any other marshalling of the assets and liabilities of the Corporation, the holder hereof shall not be entitled to participate or share, ratably or otherwise, in the distribution of the assets of the Corporation until all claims of all other present and future creditors of the Corporation arising out of any matter occurring prior to the Installment Date have been fully satisfied, or provision has been made therefor.

This loan and the various installments thereof hereinabove designated in the repayment schedule, may not be paid in whole or in part prior to the respective Installment Dates there indicated without prior notice to the New York Stock Exchange. If the loan, or any installment thereunder is paid in whole or in part on or prior to the respective Installment Dates and if at the time of any such payment the Corporation shall be insolvent, the registered holder agrees irrevocably for himself, his heirs, executors, administrators and assigns (whether or not such registered holder, his heirs, executors, administrators or assigns shall have had any knowledge or notice of such insolvency at the time of any such payment) to repay to the Corporation, its successors and assigns, the sum so paid, for the benefit of all other creditors of the Corporation; provided, however, that any suit for the recovery of any such payment must be commenced within one year of the date of such payment.

The unpaid portion of the obligation of the Corporation hereunder shall forthwith mature, together with interest accrued thereon, in the event of any receivership, insolvency, bankruptcy, assignment for benefit of creditors, reorganization, whether or not pursuant to bankruptcy laws, liquidation or any other marshalling of the assets and liabilities of the Corporation; but payment of the same shall remain subordinate as hereinabove set forth.

Default in the payment of interest or principal shall not accelerate the maturity of the obligation and payment of the obligation shall remain subordinate as hereinabove set forth.

The registered holder agrees that so long as the Corporation continues as a member corporation of the New York Stock Exchange, he will not, without the prior written approval of said Exchange, transfer, sell, assign, pledge or otherwise create, or permit to be created, any lien, charge or encumbrance upon this instrument.

The term "the Corporation", as used in this agreement shall mean Weis, Voisin, Cannon, Inc., or any successor thereto.

This agreement shall be binding upon the registered holder, his, their or its heirs, executors, administrators, successors and assigns.

This agreement shall be effective on the date it is approved by the New York Stock Exchange.

IN WITNESS WHEREOF the parties hereto have set their hands and seals this 28th day of June, 1967.

WEIS, VOISIN, CANNON, INC.

(Corporate Seal)

TWO Year Debenture Bond

By _____ Secretary

A67

WEIS, VOISIN, CANNON, INC.

TWO YEAR

# Debenture Bond

$ 15,000

REGISTERED OWNER MAY NOT SELL, ASSIGN, PLEDGE OR TRANSFER THE WITHIN DEBENTURE BOND WITHOUT THE PRIOR APPROVAL OF THE NEW YORK STOCK EXCHANGE

NOTICE—No writing on this Debenture Bond or any to be made except by an officer of the Corporation

DATE OF REGISTRY NAME AND ADDRESS OF REGISTERED HOLDER AUTHORIZED OFFICER

## EXHIBIT C

Weis, Voisin, Cannon, Inc.
Established 1927
Members New York Stock Exchange
Members American Stock Exchange
And Other Principal Exchanges

NEW YORK
111 BROADWAY
NEW YORK, N.Y. 10006
WO 4-7300

CHICAGO
50 W. ADAMS
CHICAGO, ILLINOIS 60603
641-0500

Mrs. Eva Grossmann
5840 N. Sheridan Rd.
Chicago, Ill.

ACCT. NO.

DATE: 7-2-69

WE HAVE THIS DAY (RECEIVED ☐ DELIVERED ☐) FOR YOUR ACCOUNT. (☒ CREDIT ☐ DEBIT) YOUR ACCOUNT

| DESCRIPTION | AMOUNT |
|---|---|
| Check Received 7-2-69 for Debenture Account of Customer | $5,000.00 |
| Check and receipt to be sent to Mr. Harold Federbush in New York Office | |

WEIS, VOISIN, CANNON INC.

mk

BY _____




WEIS, VOISIN, CANNON, INC.
ESTABLISHED 1927
MEMBERS NEW YORK AND AMERICAN STOCK EXCHANGES
AND PRINCIPAL COMMODITY EXCHANGES
141 W. JACKSON BOULEVARD • CHICAGO, ILL. 60604
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MID TOWN OFFICE
1385 BROADWAY, N. Y. C.
CHICAGO, ILLINOIS
NEW HAVEN, CONN.
ENGLEWOOD, N. J.
MAPLEWOOD, N. J.
FORT LEE, N. Y.
CEDARHURST, N. Y.
NANUET, N. Y.
MIAMI BEACH, FLA.


June 18, 1969

## EXHIBIT D

Mrs. Eva Grossmann
5840 N. Sheridan Road
Apartment 305
Chicago, Illinois

Dear Mrs. Grossman:

At Mr. Leo Meisselman's suggestion, enclosed is renewal of the Subordinated Debenture which will mature on July 1, 1969.

Please sign the Agreement on the second page and return to me in the enclosed envelope.

Thank you for your continued interest in this Corporation.

Very truly yours,

WEIS, VOISIN, CANNON, INC.
S/ Lillian Brage
Lillian Brage

LB:kb
Enclosures:

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

| | |
|---|---|
| In the Matter of WEIS SECURITIES, INC., Debtor. | 73 Civ. 2332 |

**STATEMENT OF MATERIAL FACTS AS TO WHICH THERE IS A GENUINE ISSUE.**

Pursuant to Rule 9(g) of the Local Rules of this Court, William J. Scott, Attorney General of the State of Illinois, ex rel. EVA GROSSMANN, submits the following statement of facts material to the motion for summary judgment as to which there is a genuine issue of facts to be tried:

1. The circumstances under which Mrs. Eva Grossmann was induced to invest her life savings in the sum of Twenty Thousand Dollars ($20,000) in subordinated debentures of Weis, Voisin & Cannon, and the manner in which the transaction was executed, including the application supposedly filed by Mrs. Grossmann with the New York Stock Exchange.

2. The automatic renewal of the debentures by Weis, Voisin & Cannon, without any notification of Mrs. Grossmann.

3. The absence of delivery to Mrs. Grossmann of the $5,000 debenture.

4. The taking over of Weis, Voisin & Cannon by Weis Securities, Inc., without any notification of Mrs. Grossmann.



5. The failure of the New York Stock Exchange to properly supervise and control Weis, Voisin & Cannon and Weis Securities, Inc.

6. The time when Mrs. Grossmann learned of the bankruptcy of Weis, Voisin & Cannon and Weis Securities, Inc.

DATED: February 21, 1975

WILLIAM J. SCOTT
Attorney General
of the State of Illinois
ex rel. Eva Grossman
By: s/ Fred F. Herzog,

Fred F. Herzog
First Assistant Attorney General
160 North LaSalle Street - Suite 800
Chicago, Illinois 60601
(312) 793-2457

STATE OF ILLINOIS }
COUNTY OF COOK } SS

*AFFIDAVIT OF EVA GROSSMANN*

EVA GROSSMANN, of 5650 North Sheridan Road, Chicago, Illinois 60660, after having been duly sworn, upon oath, deposes and says:

1. This affidavit is submitted in opposition to the Trustee's motion for summary judgment and in support of affiant's claim herein.

2. I was born in Cluj, Romania, on July 29, 1922. After having attended the grammar and high schools in Cluj, Romania, I was taken by the Nazis in 1943 to the infamous concentration camp in Auschwitz as slave laborer. I remained in that camp until September, 1943, when I was transported as slave laborer to a camp in Czechoslovakia, where I worked in a German munitions factory. I was freed in June, 1944, by the advancing Russian army. Having returned to Romania, I married in October, 1947, Ernest Grossmann.

3. After my husband and I had left Romania, we emigrated to the United States in 1950. Shortly after my arrival in Chicago I obtained a job as a fitter in the Charles A. Stevens Department Store in Chicago, Illinois. With the exception of two years I have worked continuously on the same job from that time on, and I am still presently employed as a fitter at Charles A. Stevens.

4. My husband, who had worked as a bookkeeper in Chicago, passed away in March of 1967. We both had accumulated savings in the amount of $15,000. After his death I received, in addition thereto, $5,000 from a life insurance policy which my husband had taken out for my benefit.



5. One of the customers of the Charles A. Stevens store, whom I regularly fitted, was Mrs. Leo Meiselman. She was aware of the fact that my husband had passed away and during one of the fittings she told me that her husband, who was an official of the Weis, Voisin & Cannon brokerage firm in Chicago, had invested successfully funds for several widows and had helped out other people in their investment problems. She suggested that I get in touch with him. I did so, and told him that I had a total of $20,000 available for investment purposes, which constituted mine and my husband's life savings. He in turn advised me that I invest first $15,000 and, later on, an additional $5,000, in securities of Weis, Voisin & Cannon. He explained to me that this investment was like a loan to the company. He did not mention anything of "subordinated debentures". Even if he had mentioned that term to me, I wouldn't have understood it, since I didn't know and still don't know what it meant, and what its real significance is. I thought at the time of the investment that these debentures were really nothing else but shares of stock in Weis, Voisin & Cannon, and that I owned stock in the company. I have no knowledge whatsover of finances or of the stock market, and am not familiar with any financial terms.

6. At the time when Mr. Meiselman asked me to invest my savings in the debentures he told me that this would be the best investment for me, since it would pay the highest interest. I relied and acted solely upon his advice and trusted him completely, since he was the expert in a field of which I had no knowledge whatsoever. At the time of the investment he also asked me to make out an application and to shown him proof of my citizenship. I don't know and did not ask him to whom and for what purpose the application had to be made out; I simply followed his in-

structions. I cannot recall today whether he made out the application upon information which I gave him or whether I made it out myself. Upon his prodding, I or he wrote down on the application that my financial worth was $30,000, which included the value of my furniture, some money in a checking account for living expenses, some government bonds, and some pieces of jewelry.

7. The debentures in which I had invested my $20,000 were supposedly automatically renewed; however, to my knowledge, I never received a renewal notice. I also never received a certificate for the additional $5,000 debenture, which I had bought after the purchase of the $15,000 debenture, again upon the advice of Mr. Meiselman. I received quarterly checks, first in the amount of 8%, and later in the amount of 9% as interest on the debentures.

8. In 1971, I learned that Mr. Meiselman had left Weis, Voisin & Cannon and, later on, that Weis Securities had taken over the firm of Weis, Voisin & Cannon; I never received any notification of that fact.

9. In 1972, when I once did not receive my quarterly check, I contacted Weis, Voisin & Cannon in Chicago, and was told that a Mr. Raike (I don't know the exact spelling) had taken over Mr. Meiselman's account and that no proof of my debentures could be found on the firm's records in Chicago. However, afterwards I received a phone call from Mr. Raike and he told me that matter was straightened out; I then received my interest checks again.

10. As previously indicated, I never received any notification of a renewal of the debentures or of the take-over of



Weis, Voisin & Cannon by Weis Securities. As I recall, I learned of the bankruptcy of Weis, Voisin & Cannon or Weis Securities through the newspapers in May or June, 1973.

s/ Eva Grossmann

SUBSCRIBED AND SWORN TO
before me this 21st day of
February, 1975.

Notary Public

Supreme Court, U. S.
FILED
DEC 4 1978
MICHAEL RODAK, JR., CLERK

IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1978**

No. 78-746

EVA GROSSMANN,

*Petitioner,*

*vs.*

EDWARD S. REDINGTON, Trustee, and SECURITIES INVESTOR PROTECTION CORPORATION,

*Respondents.*

## RESPONDENT'S BRIEF IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

JAMES B. KOBAK, JR.
*Attorney for respondent*
EDWARD S. REDINGTON,
*Trustee for the liquidation of the business of Weis Securities, Inc.*
One Wall Street
New York, New York 10005
(212) WH. 3-6500

*Of Counsel*
DAVID W. WILTENBURG
HUGHES HUBBARD & REED

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IN THE

# Supreme Court of the United States

**October Term, 1978**

No. 78-746

EVA GROSSMANN,

*Petitioner,*

vs.

EDWARD S. REDINGTON, Trustee, and SECURITIES INVESTOR PROTECTION CORPORATION,

*Respondents.*

## RESPONDENT'S BRIEF IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

### Preliminary Statement

This Brief is submitted by respondent Edward S. Redington, Esq., the Trustee appointed by order of the United States District Court for the Southern District of New York (the "Trustee") to liquidate the business of Weis Securities, Inc. ("Weis") pursuant to the Securities Investor Protection Act of 1970, 84 Stat. 1636, (formerly) 15 U.S.C. §§ 78aaa *et seq.* (1970) ("SIPA" or the "1970 Act")[1] in opposition to the petition for a writ of certiorari

1. The Securities Investor Protection Act was amended in important respects in 1978. Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, 92 Stat. 249 (1978) (to be codified in 15 U.S.C. §§ 78 aaa *et seq.*). As discussed at pages 8-9, *infra*, one effect of those amendments is to make clear that a claimant such as petitioner cannot obtain, by rescission or otherwise, the preferred status of a "customer" which petitioner seeks. Securities Investor Protection Act Amendments of 1978 § 15, 92 Stat. 271 (to be codified in 15 U.S.C. § 78 lll (3)(B)).

to review the decision of the United States Court of Appeals for the Second Circuit entered on June 12, 1978.

## Counter-Statement of Question Presented

Whether, in the liquidation of a brokerage house under SIPA as it existed at the time of the Weis liquidation, where the brokerage house had been permitted by regulatory authorities to deal with the public on the strength of subordinated capital contributed pursuant to a statutorily required net capital rule designed to protect customers and ensure public confidence in broker-dealers in securities, individual reliance in fact by thousands of customers and creditors of the brokerage house on an approved lender's subordination agreements is a necessary element that must be proved to exist in spite of the net capital rule before a subordinated lender can be estopped from rescinding such an agreement and claiming preferential treatment as a "customer," to the detriment of genuine customers and other creditors of the brokerage house?

## Counter-Statement of the Case

The decision below involves the type of treatment that should be afforded subordinated lenders who assert fraud or similar claims in brokerage house liquidations. Thanks to recent amendments to both the Bankruptcy Act and SIPA, this question is now entirely controlled by statute. See pages 8-9, *infra*. At the time of the Weis liquidation in 1973, SIPA provided that the term "customer" excluded persons whose claims involved subordinated loans or the return of property that had been "part of the capital of the debtor," SIPA § 6(c)(2)(A)(ii), (formerly) 15 U.S.C. § 78 fff (c)(2)(A)(ii) (1970), but did not specifically



address the rescission arguments advanced by the subordinated lenders in this liquidation.

Subordinated loans play a unique role in the financing and regulation of broker-dealers. The proceeds of such loans, once approved by regulatory authorities, are used as capital in the business of the broker-dealer and are counted as "net capital" in applying to the broker-dealer the net capital and other financial responsibility rules with which the broker-dealer must comply in order to continue doing business with the public. The circumstances under which loan proceeds may be used as "net capital" are defined and monitored by the New York Stock Exchange (the "Exchange") as part of the regulatory scheme enacted by Congress in the Securities Exchange Act of 1934 and administered by the Securities and Exchange Commission and the Exchange.[2] The key requirement is that the lender promise "irrevocably" to subordinate his claim for the return of property loaned to the claims of all other creditors.[3] Subordinated lenders generally receive high rates

2. Exchange Rule 325 governs net capital requirements for member firms. It was promulgated by the Exchange in its capacity as a self-regulatory authority under Section 6(d) of the Exchange Act, 15 U.S.C. § 78f(d), and was approved by the SEC on the theory that it was "more comprehensive" than the SEC's own net capital rule applicable to over-the-counter broker-dealers. The SEC rule also requires subordination of loans if they are to be counted as net capital and precludes rescission of subordination agreements "by mutual consent or otherwise," if rescission would cause the broker to exceed the required ratio. Rule 15c3-1d (c)(1), 17 C.F.R. § 240.15c3-1d(c)(1).

3. The prospective lender was required to submit a personal application for approval to the Exchange. Loan agreements had to be accompanied by an opinion of counsel stating that the subordination provisions were valid and enforceable, and the loan agreements became effective only upon Exchange approval of their terms; the required terms included not only the subordination provision but also limitations on premature withdrawal without Exchange consent or withdrawal even upon maturity when the broker-dealer was insolvent or in violation of the net capital rules. A copy of the agreement itself was required to be filed with the Exchange.

of interest in return for their investments.

Weis had over fifty subordinated lenders who contributed more than nineteen million dollars of capital to Weis. As would be the case with most broker-dealers, this capital constituted the bulk of Weis' "net capital" on the filing date.

The present litigation arose from the claims involving some twelve million dollars of twenty-three subordinated lenders who asserted that they could achieve the status of general creditors or even, as petitioner contends, be treated as customers[4] by rescinding their subordination agreements on the ground of fraud in the inducement. Most of these lenders alleged nondisclosure or misrepresentations of material facts relating to the financial condition of Weis in late 1972 and early 1973. These allegations were based on criminal indictments or informations returned against a small cadre of Weis officers who eventually were convicted for false reporting of Weis' financial condition.[5]

The Trustee moved for summary judgment against these rescission claims in the Bankruptcy Court on the ground that, even assuming that fraud or other possible grounds for rescission could be shown, the position of the lenders as contributors of subordinated net capital to Weis would make rescission inequitable as to the other creditors and customers of Weis. Under the Trustee's motion, the claims of the twenty-three lenders would be allowed in the Weis liquidation, but in a subordinated capacity. The issue

4. A "customer" receives preferential treatment under SIPA. Extending customer status to persons not entitled to such preferential treatment dilutes the amounts that can be distributed to other customers and to general creditors.

5. Mrs. Grossmann actually alleged a factually weaker case for rescission than was alleged by the other lenders. Mrs. Grossmann made her investment in 1967 and 1969, several years before any fraud is alleged to have occurred. Her investment yielded regular quarterly interest payments for nearly six years before it soured.



argued and decided below was whether reliance on the lenders' agreements by over 30,000 customers and nearly 2,000 other creditors would have to be proved as a fact in some way (thus making summary judgment inappropriate) before the lenders could be precluded from rescinding the subordination features of their agreements.

Bankruptcy Judge Babitt denied the Trustee's motion with respect to all the subordinated lenders opposing the Trustee's position. The Bankruptcy Judge interpreted dictum in a Second Circuit decision, *In re Credit Industrial Corp.*, 366 F.2d 402 (2d Cir. 1966) *("CIC")*, as requiring proof of reliance in fact in all cases despite the fact that the *CIC* case did not involve a regulated industry comparable to the securities industry.

The District Court (Wyatt, J.) reversed with respect to all subordinated lenders, including Mrs. Grossmann, in a thirteen page opinion. Judge Wyatt reasoned that the Second Circuit's statements in *CIC* were dictum which did not control in this liquidation. The District Court held that proof of reliance would either be unnecessary or that reliance could be presumed to exist in this regulated industry where the lenders' agreements permitted Weis to comply with net capital rules—a *sine qua non* for Weis' remaining in business. (A28.)

The Court of Appeals affirmed the opinion of the District Court in a sixteen page opinion. After distinguishing *CIC* (A8-A9), the court concluded that factual issues relating to individual reliance by customers were irrelevant in view of the congressionally-mandated regulatory scheme. The Court relied on a line of cases from the field of bank liquidations holding that contributors to the capital of banks must stand by undertakings that have satisfied regulatory requirements and allowed banks to do business with the public. (A9-A12.)

In addition to rejecting the right to rescind claimed by all the lenders, the Second Circuit treated separately, and rejected, a series of arguments raised on behalf of Mrs. Grossmann, including all the arguments raised in the petition.[6] On Mrs. Grossmann's argument for special treatment the court stated its conclusions as follows:

> "[Mrs. Grossmann] says that when she purchased 20,000 of Weis subordinated debentures she did not fully understand the benefits and risks of her investment. She concedes that she did know that her investment as a loan to Weis would return about the highest rate of interest of any investment she could make. At oral argument before us, her attorney acknowledged that she had received several thousand dollars in interest during the six years she had owned the debentures prior to the liquidation of Weis. She nevertheless argues that, because of her peculiar lack of sophistication, she never became a party to a subordinated debenture agreement; and that she actually was a general creditor or customer of Weis within the meaning of § 6(c)(2)(A)(ii) of SIPA. We find no merit in this contention and hold that there is no basis for treating Mrs. Grossmann any differently than the other lenders." (A13-14; footnote omitted.)

On Mrs. Grossmann's argument that a constructive trust should be imposed, the court held that no relief was possible because there was no *res* upon which a trust could be imposed. (A14-A15.) The opinion, of course, does not

6. Mrs. Grossman, whose maximum claim could only be for $20,000 less interest received, has had the good fortune to have been represented throughout these proceedings by the office of the Attorney General of the State of Illinois. The Attorney General's office has apparently become involved out of a general concern for defrauded citizens rather than from any particularized State interest. (Petition, p. 5.)



affect Mrs. Grossmann's rights under New York Stock Exchange Rules or the common law against Mr. Meiselman, the New York Stock Exchange or anyone else outside the Weis liquidation.

Petitions for rehearing filed on behalf of Mrs. Grossmann (A17) and one other lender were denied. Of all the Weis subordinated lenders, Mrs. Grossmann is the only one to have pursued the matter to this Court.

## The Reasons For Denying The Petition

### 1. The Decision Below Was Correct.

The result of the decisions below is to allow Mrs. Grossmann's claim in the Weis liquidation but on a subordinated basis consistent with the terms of the subordinated debentures which she purchased in 1967 and 1969 in exchange for generous interest payments. The decision below does not deprive Mrs. Grossmann of rights that she may have outside of the Weis liquidation against Mr. Meiselman or others based on violations of New York Stock Exchange Rules or the law of Illinois. Its only effect is on the treatment of her claim *vis-a-vis* other persons with sympathic claims—unsubordinated creditors and customers in the Weis liquidation.

The decisions of both the Court of Appeals and the District Court with respect to all Weis' subordinated lenders, including Mrs. Grossmann, are eminently sensible and in accord with the prior decisions of this and other Courts. To prevent any future dispute about such issues, Congress has amended both the Bankruptcy Act and SIPA to ensure that precisely the result reached with respect to Mrs. Grossmann and the other lenders below will obtain in future liquidations. See Section 2, *infra*.

**2. The Importance of the Question of Law Decided by the Second Circuit Has Been Vitiated by Recent Amendments to SIPA and the Bankruptcy Act.**

Congress has recently amended SIPA specifically to prevent a subordinated lender fom being treated as a "customer", "notwithstanding that some ground exists for declaring [the lender's subordination] contract, agreement, or understanding void or voidable in a suit between the claimant and the debtor." Securities Investor Protection Act Amendments of 1978 § 15, 92 Stat. 271 (1978) (to be codified in 15 U.S.C. § 78 lll (3)(B)). Thus the arguments advanced on behalf of Mrs. Grossmann for customer treatment under the original SIPA will have no application to cases arising in future liquidations under the amended statute.

The limited impact of the issues raised on behalf of Mrs. Grossmann in future liquidations is further underscored by Section 510(b) of the new Bankruptcy Act signed by the President last month. Pub. L. No. 95-598, 92 Stat. 2549 (1978) (to be codified in 11 U.S.C. §§ 101 *et seq.*). Congress has made a policy judgment that the same result reached by the Second Circuit with respect to subordinated lenders in this regulated industry should apply to investors in all industries.

Section 510(b) provides:

> "(b) Any claim for rescission of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security shall be subordinated for purposes of distribution to all claims and interests that are senior or equal to the claim or interest represented by such security."

A "security" is defined by Section 101(35)(A)(v) to include "debentures" such as those purchased by Mrs. Grossmann.



These provisions will be applicable to future SIPC liquidations as well as to ordinary bankruptcies by virtue of the amended SIPA, which states that a SIPA liquidation shall be conducted "in accordance with, and as though it were being conducted under, the Bankruptcy Act." Securities Investor Protection Act Amendments of 1978 § 8, Pub. L. No. 95-283, 92 Stat. 259 (1978) (to be codified in 15 U.S.C. § 78fff (b)).

The principles applied by the courts below to Mrs. Grossmann's claim in this liquidation have been determined by the legislature to be the principles that will apply to all similar claims in all future liquidations. A decision on the issue by this Court is therefore unnecessary and would not affect the future development of the law.

**3. The Decision Below Does Not Call for An Exercise of Supervisory Power By This Court.**

There has never been serious dispute that rescission is precluded if third parties have relied on the promise which the rescinding party attempts to repudiate. The question below was whether reliance on the lenders' agreements by some or all of the 30,000 customers and nearly 2,000 general creditors of Weis had to be proved as a fact in order to preclude rescission. This hopeless burden would entail proof of the very antithesis of what Congress intended in subjecting brokerage houses to extensive financial regulation—that customers wishing to invest in the securities market be *relieved* of the burden of having to make sophisticated inquiries into an individual broker's finances. H.R.Rep. No. 1383, 73d Cong., 2d Sess. at 3 (1934).

Because any other decision would have destroyed the efficacy of the net capital rules, both the District Court and the Court of Appeals held that reliance could either be presumed to exist or that proof of this element could be dis-

pensed with as a matter of law because of the pattern of regulation that exists in this industry. (A12-A13; A28.) A principal issue below was the application of dictum in a prior Second Circuit case, *In re Credit Industrial Corp.*, 366 F.2d 402 (2d Cir. 1966), a case involving subordination agreements in an unregulated industry. The Second Circuit refused to extend this dictum to this heavily regulated industry in a senseless and inflexible manner that would have done violence to the net capital rule. (A8-A9, A13.) The Second Circuit's interpretation of its own prior statements is scarcely a question calling for review by this Court. Moreover, the Second Circuit's disposition of the matter has now been established as the law for the future by legislation.

**4. The Decision Below Does Not Conflict with Decisions of This Court or Any Court of Appeals.**

There is no conflict among the circuits, or between the decision below and the prior decisions of this Court, on the issues involved here. Quite the contrary, the holdings of the Court of Appeals and the District Court are consistent with the holdings of a long line of federal and state cases, including a series of decisions by this Court, insisting on strict enforcement of the obligations of defrauded lenders or shareholders in the liquidations of banks and insurance companies which have in the past been subject to comparable systems of regulation. *E.g.*, *Oppenheimer* v. *Harriman National Bank & Trust Co.*, 301 U.S. 206, 215 (1937); *Lantry* v. *Wallace*, 182 U.S. 536, 552-53 (1901); *Scott* v. *Deweese*, 181 U.S. 202 (1901); *Julian* v. *Stewart*, 56 F.2d 32 (5th Cir. 1932); *Anderson* v. *Cronkleton*, 32 F.2d 170 (8th Cir. 1929); *Hurd* v. *Kelly*, 78 N.Y. 588 (1879); 1A A. Corbin, *Contracts* §§ 197, 200 at 219-20 (1963).



**5. The Decision Below Correctly Applied the Law to The Factual Assertions of Mrs. Grossmann.**

The petition does not call into question any of the principles of law applied by the courts below. Rather, it wistfully argues that different rules should have been applied to Mrs. Grossmann because she was less "sophisticated" than the other lenders.

The record here does not disclose that any error of fact was made by the courts below with respect to Mrs. Grossmann, much less an error of such enormity that it requires consideration by this Court. Every conceivable argument for separate treatment for this one claimant was advanced below, including such points as the constructive trust argument renewed in the petition, arguments based on the factually inapposite Illinois Bulk Sales Act and arguments based on the Exchange's "know your customer rule" which has never been held to provide a right to relief in circumstances such as the present or to determine the enforceability of subordination agreements under SIPA. These arguments were all considered, and rejected, by the Court of Appeals (A13-A14).

Contrary to the principal contention urged by the Attorney General on behalf of Mrs. Grossmann, the facts recited in her affidavit in opposition to the Trustee's motion for summary judgment show that she did not misapprehend the essential nature of the investment. Mrs. Grossmann states in her affidavit that the Weis officer with whom she dealt "explained to me that this investment was like a loan to the company" (A73) and that

> "I thought at the time of the investment that these debentures were really nothing else but shares of stock in Weis, Voisin & Cannon, and that I owned stock in the company." (*Id.*)

At the time relevant to her claims, as now, SIPA defined the term customer to *exclude*

> ". . . any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor." (SIPA Section 6(c)(2)(A)(ii), (formerly) 15 U.S.C. § 78fff(c)(2)(A)(ii) (1970).)

Mrs. Grossmann's own "understanding" was that her property would become part of "the capital of the debtor" rather than being entrusted to Weis to trade in shares of publicly traded companies. As the Second Circuit held (A13-A14), this was enough, even before the statute was amended, to prevent her from receiving "customer" status. *See, e.g., SEC* v. *F.O. Baroff Co.*, 497 F.2d 280 (2d Cir. 1974).

## Conclusion

For the foregoing reasons, the petition for a writ of certiorari should be denied in all respects.

Dated: New York, New York
December 4, 1978

Respectfully submitted,

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Supreme Court, U. S.
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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1978

**No. 78-746**

EVA GROSSMANN, *Petitioner,*

v.

EDWARD S. REDINGTON, Trustee, and
SECURITIES INVESTOR PROTECTION CORPORATION,
*Respondents.*

**On Petition For A Writ Of Certiorari**
**To The United States Court of Appeals For The Second Circuit**

## BRIEF IN OPPOSITION OF RESPONDENT SECURITIES INVESTOR PROTECTION CORPORATION

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IN THE

# Supreme Court of the United States

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EVA GROSSMANN, *Petitioner,*

v.

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*Respondents.*

**On Petition For A Writ Of Certiorari**
**To The United States Court of Appeals For The Second Circuit**

## BRIEF IN OPPOSITION OF RESPONDENT SECURITIES INVESTOR PROTECTION CORPORATION

### QUESTION PRESENTED

Respondent Securities Investor Protection Corporation ("SIPC") respectfully submits that the five "Questions Presented" set forth in the Petition are imprecise and inadequate. The only question presented is:

> In a proceeding for the liquidation of a broker-dealer under the Securities Investor Protection Act of 1970[1] ("SIPA") should a subordinated lender

[1] 15 U.S.C. §§ 78aaa *et seq.* SIPA was amended in important and presently material respects in 1978. Pub. L. No. 95-283, 92 Stat. 249 (1978). Unless otherwise noted references and citations herein are to SIPA prior to the 1978 amendments.

to that broker-dealer be estopped for rescinding her subordination agreement, in order to obtain preferred "customer" status under SIPA, by reason of an overriding public policy requiring the enforcement of such agreements for the benefit of other creditors in light of financial responsibility rules promulgated under the federal securities laws, irrespective of proof of actual reliance on such agreement by securities customers of the broker-dealer?[2]

## JURISDICTION

The Petitioner invokes the jurisdiction of this Court under 28 U.S.C. § 1254(1). However, this being a controversy in bankruptcy the jurisdiction of this Court is also primarily derived from 11 U.S.C. § 47(c).[3]

## STATEMENT OF THE CASE

This case arises in a proceeding for the liquidation under SIPA of Weis Securities, Inc. ("Weis"), a former member of the New York Stock Exchange ("Exchange"). Petitioner is a subordinated lender to Weis by reason of her purchases of its subordinated debentures nearly six years prior to its demise. The Respondents are SIPC which commenced the liquidation proceeding, and Edward S. Redington, Esq. who was appointed the Trustee in liquidation.

Petitioner and over twenty other subordinated lenders of Weis filed claims with the Trustee asserting that they were entitled to rescind their subordination agreements and to be treated, in the distribution of Weis' assets, at least on a par with Weis' general creditors. Petitioner and some of the other subordinated lenders asserted, in addition, that upon rescission they should be treated as securities "customers" of Weis as that term is defined in SIPA [15 U.S.C. § 78fff (c)(2)(A)(ii)]. Thus they claimed the preferential treatment provided to customers including advances from SIPC's funds to satisfy their claims.[4] Most of these subordinated lenders grounded their claims for rescission on alleged fraudulent nondisclosure or misrepresentations by Weis of material facts relating to its financial condition as of late 1972 and early 1973.[5]

---

[2] Despite the implication to the contrary in the Petitioner's statement of the "Questions Presented" and throughout the Petition itself, the nature of the relief to be afforded to the Petitioner is not yet ripe for decision. Accordingly, should this Court grant the writ of certiorari and subsequently answer the question presented in the negative, thus reversing the decision of the United States Court of Appeals for the Second Circuit, this case would have to be remanded for trial not only on the issue of reliance by members of the public but also as to the actual merits of Petitioner's asserted right to relief on various theories.

[3] *See, Mitchell Store Building Co.* v. *Carroll,* 232 U.S. 379 (1914). A liquidation proceeding under SIPA is substantially governed by provisions of the Bankruptcy Act except to the extent they are inconsistent with SIPA. *See,* 15 U.S.C. § 78fff(c)(1). Insofar as it provides for liquidation proceedings, SIPA is predominantly an exercise of the bankruptcy power of the Congress. *Exchange National Bank* v. *Wyatt,* 517 F.2d 453, 459-460 (2d Cir. 1975). The *Wyatt* case holds that appeals to the Court of Appeals are governed by § 24a of the Bankruptcy Act, 11 U.S.C. § 47a.

[4] The rights of "customers" were generally described in *SIPC* v. *Barbour,* 421 U.S. 412 (1975).

[5] The Trustee and SIPC have sued Weis' accountant in connection with its certification of financial statements for Weis which did not fairly represent Weis' financial condition at the time in question. That lawsuit is presently the subject of a writ of certiorari issued by this Court to the United States Court of Appeals for the Second Circuit. *Touche Ross & Co.* v. *Redington,* Dkt. No. 78-309.

However, Petitioner based her claim merely on her own lack of sophistication and on Weis' alleged failure, years earlier, to inform her that the loans which she admittedly knew would be used as part of Weis' capital would be subordinated to claims of other creditors.

Bankruptcy Judge Babitt denied the Trustee's motion for summary judgment, holding that the subordinated lenders could be estopped from rescinding only if the Trustee could prove actual reliance by Weis' customers and creditors on the subordination agreements. The district court (Wyatt, J.) reversed and the court of appeals affirmed the district court. The court of appeals, noting the importance of the regulatory structure of the securities industry, held that regardless of reliance by customers, ". . . where a lender subordinates his loan to a securities broker—to enable the broker to comply with regulatory capital requirements—he is estopped from rescinding the subordination agreement." (A13)[6]

## REASONS FOR DENYING THE WRIT

### I

### PETITIONER HAS FAILED TO DEMONSTRATE THAT THE QUESTION PRESENTED IS "CERTWORTHY" WITHIN THE MEANING OF THIS COURT'S RULE 19 AND THE CRITERIA ESTABLISHED BY ITS DECISIONS.

#### Far From There Being A Conflict Among The Circuits Or With Applicable Decisions Of This Court, The Result Below Has Been Followed By Other Courts Considering The Same Matter, And Is Fully Consistent With Analogous Decisions Of This Court.

While Petitioner makes no claim that there is a conflict among the circuits, she does assert that the decision below is in conflict with applicable decisions of this Court within the meaning of Rule 19(b). Petition at 14. There is no such conflict. The holdings of both the court of appeals and the district court below are in full accord with a long line of federal and state cases which have required strict enforcement of the obligations of defrauded lenders or stockholders in the liquidations of banks and insurance companies—entities which, like stockbrokers, are affected with a considerable public interest and have been subject to comprehensive state or federal regulation. This line of cases includes a series of decisions by this Court. *See, e.g., Oppenheimer* v. *Harriman National Bank & Trust Co.,* 301 U.S. 206, 214 (1937); *Lantry* v. *Wallace,* 182 U.S. 536, 552-553 (1901); *Scott* v. *DeWeese,* 181 U.S. 202 (1901); *Julian* v. *Stewart,* 56 F.2d 32 (5th Cir. 1932); *Anderson* v. *Cronkleton,* 32 F.2d 170 (8th Cir. 1929); *Hurd* v. *Kelly,* 78 N.W. 588 (1879). In fact, and most recently, two district judges in another circuit, after independent analysis, followed the decision of the district court below. *Redington* v. *Exchange National Bank of Chicago,* Civil Action No. 75 C 2661 (N.D. Ill., November 8, 1977) and *Redington* v. *O'Hare International Bank,* Civil Action No. 75 C 2951 (N.D. Ill., March 21, 1978).[7]

There is clearly no need for this Court's intervention to reconcile opposing judicial views of the law.

[6] The reference is to page A13 of the Appendix to the Petition.

[7] No appeals were taken in either case and the time for appeals has passed.

**This Case Does Not Involve ". . . An Important Question Of Federal Law Which Has Not Been, But Should Be, Settled By This Court . . . ." Congress Has Effectively Codified The Result Below By Recent Amendments To SIPA And Further Fortified That Result By Amending The Bankruptcy Act.**

When this litigation arose the term "customers" was defined in SIPA to specifically *exclude* ". . . any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor . . . ." 15 U.S.C. § 78fff(c)(2)(A)(ii). Petitioner contends that, if allowed to rescind, she will escape this exclusionary clause and be deemed a customer of Weis entitled to preferential treatment under SIPA. Whether this is so or not,[8] the importance of this question has been vitiated because SIPC was amended in May of 1978 in a manner which effectively codifies the result below. The amended definition of "customers" specifically excludes:

> (B) Any person to the extent that such person has a claim for cash or securities which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor, or is subordinated to the claims of any or all creditors of the debtor, *notwithstanding that some ground exists for declaring such contract, agreement, or understanding void or voidable in a suit between the claimant and the debtor.*

Emphasis added. 15 U.S.C.A. § 78*lll*(3) (Supp. 2, 1978).

This amendment precludes rescission as a means of gaining "customer" status. It was suggested to the Congress by SIPC specifically because of this litigation. H.R. Rep. No. 95-746, 95th Cong. 1st Sess. 46-47 (1977); *See, id.* at 33-34.

In addition to amending SIPA, Congress also this year completely rewrote the Bankruptcy Act. The new Bankruptcy Act, which in pertinent part becomes effective in October of 1979, includes the following § 510(b) [11 U.S.C. § 510(b)]:

> Any claim for rescission of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security shall be subordinated for purposes of distribution to all claims and interests that are senior or equal to the claim or interest represented by such security.

The term "security" is defined in the new Bankruptcy Act to include "debentures" such as those purchased by Petitioner herein. 11 U.S.C. § 101(35)(A)(v). These provisions of the new Bankruptcy Act will apply in liquidations under SIPA pursuant to § 6(b) of SIPA as amended [15 U.S.C.A. § 78fff(b) (Supp. 2, 1978)], and as further amended by § 308(g) of the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598.

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[8] Even if this Court takes this case and reverses the court of appeals, it is doubtful that Petitioner can obtain, after trial, the status of "customer". Not only will she have to prove the fraud which she has alleged and which to date has only been assumed for purposes of argument, but she will have to demonstrate that she fits the customer definition set forth in SIPA and that she *does not* fit into other portions of the exclusionary clause set forth above. For example, even with her subordination agreement rescinded, it may well be that Petitioner is a person who ". . . has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor. . . ." It should be noted that Petitioner has admitted that she thought she was becoming a shareholder of Weis, a position even less envious than that of subordinated lender. (A73)

## II

**THE COURT OF APPEALS WAS CLEARLY CORRECT IN REJECTING PETITIONER'S CONTENTIONS AND IN HOLDING THAT SUBORDINATED LENDERS WHOSE LOANS WERE USED TO ENABLE THE STOCKBROKER TO COMPLY WITH "REGULATORY CAPITAL REQUIREMENTS" MAY NOT RESCIND THEIR SUBORDINATION AGREEMENTS, EVEN ABSENT PROOF OF ACTUAL RELIANCE BY CUSTOMERS.**

The court of appeals based its holding in principal part ". . . on considerations of sound public policy" (A12) manifested by the system of regulation to which Weis was subject. As the court stated (A9):

> . . . [T]he instant case involves the attempted rescission of a promise or obligation intended to allow a company to satisfy regulatory requirements and of promises made by the company to regulatory authorities. We therefore have an additional factor—regulatory interest—to consider in determining whether it is here "reasonable and necessary" to require reliance on the subordination agreements. Our inquiry must focus on whether the element of reliance has any place in the regulatory scheme of Congress.

The "regulatory requirements" referred to by the court of appeals are primarily the "net capital" rules of the Securities and Exchange Commission ("SEC") and the Exchange. The "promises" are those made by lenders in their subordination agreements which must be approved by the Exchange.[9]

[9] A subordination agreement must be approved by the Exchange before it becomes effective. The Exchange requires the agreement to subordinate the lender's claim to the claims of all other creditors of the broker-dealer; to waive any right to participate in the assets of the broker-dealer's estate until the claims of all other creditors have been satisfied in full; and to contain provisions preventing the lender from withdrawing his property before the expiration date of the loan without the written consent of the Exchange, and precluding withdrawals even upon expiration if the broker-dealer is insolvent or in violation of the net capital rules. Pp. 167-68, 226, 268-69, 303-04, and 325-26 of the Joint Appendix in the court of appeals.



The "net capital" of a broker or dealer is essentially his adjusted "net worth", as defined in SEC Rule 15c3-1 [17 C.F.R. § 240.15c3-1]. "[T]he principal purpose of the rule is to require that the capital position of a broker or dealer will always be sufficiently liquid to cover his current obligations, in order to be able at all times to promptly meet the demands of customers." Securities Exchange Act Release No. 8024 (January 18, 1967). As a member of the Exchange, Weis was exempt from the SEC's net capital requirements [10] and was subject to the more stringent net capital requirements of Exchange Rule 325 promulgated pursuant to section 6(d) of the Securities Exchange Act of 1934. The net capital rule is the "principal regulatory tool" used to monitor the financial soundness of brokers and dealers. Press Release, January 10, 1973 [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 79,174 at 82,578 (remarks of Senator Harrison A. Williams, Chairman of the Senate Securities Subcommittee). The courts have described the rule as "one of the most important weapons in the Commission's arsenal to protect investors", *Blaise D'Antoni & Associates, Inc.* v. *SEC*, 289 F.2d 276, 277 (5th Cir.), *cert. denied*, 368 U.S. 899 (1961) and as "one of the most important provisions

[10] SEC Rule 15c3-1(b)(2) exempts members in good standing of certain national securities exchanges. The exemption is granted by the SEC following its review of the exchange rule and determination that the exchange rule is more comprehensive. See, Securities Exchange Act Release No. 3617 (Nov. 8, 1944).

designed to protect the investing public . . . ." *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, 534 F.2d 156, 173 (9th Cir. 1976)."

Subordinated loans play a unique and vital role in the financing of stockbrokers and the operation of the net capital rule. In computing a brokerage firm's net capital ratio, subordinated loans are excluded from aggregate indebtedness and included in net capital. "The subordination of a loan thus has the effect of converting what would otherwise be a liability into a net capital asset." Wolfson & Guttman, *The Net Capital Rules For Brokers And Dealers*, 24 Stan. L. Rev. 603, 624 (1972) (hereinafter "Wolfson & Guttman"). A subordinated lender makes his rights subordinate to those ". . . of the three major classes of creditors of the broker or dealer, his customers, banks, or other brokers or dealers, and to the rights of all his other general creditors as well . . . . Since the subordination is intended to assure the customers will be protected, the subordinated loan is assumed to contain sufficient characteristics of equity to warrant its inclusion in net capital." *Id.* at 625.

The use of subordinated liabilities as part of a firm's capital is one of the key elements in providing the liquidity which is a primary objective of the net capital rule. *See,* E. Weiss, *Registration And Regulation Of Brokers And Dealers* 58 (1965). "It may be noted that no other means than a satisfactory subordination agreement can be utilized to accord a liability the treatment of being added to capital for purposes of the

[11] The importance of the net capital rule far outweighs Petitioner's interest in enforcement of Exchange Rule 405, contrary to her contentions otherwise. Petition at 11-14, 15-16.



net capital rule." *Id.* at 67. The availability of this capital is vitally important to customers of brokerage firms. Its sudden withdrawal can spell disaster for the firm and its customers. Wolfson & Guttman, *supra,* at 625; *see,* H. Baruch, *Wall Street: Security Risk* 177-179 (1971).

The court of appeals considered the regulatory context of this case and decided that proof of actual reliance by customers was unnecessary in order to estop rescission by Petitioner and the other subordinated lenders. As noted above (at p. 5) the court relied heavily on a long line of state and federal cases, including decisions of this Court, establishing that lenders and shareholders in companies in the heavily regulated banking and insurance communities would not be allowed to rescind their agreements and thereby adversely affect the interests of creditors of those companies in liquidation.

**Petitioner's Miscellaneous Arguments Lack Merit**

The Petition depicts a hyperbolic scenario of adverse consequences on a grand national scale stemming from the decision sought to be reviewed. *See, e.g.,* Petition at pp. 8, 10-11. Beneath the rhetoric, however, there is little to merit the attention of this Court. Petitioner's principal contentions have been answered above. Her subsidiary contention appears to be that she has been denied common law and state statutory rights which Congress intended to preserve for her.

There is, of course, no common law or state statutory right to the protections afforded to customers under SIPA. In any case, whatever rights Petitioner has at common law or under Illinois statutes can be pursued

against the agent of Weis who sold her the debentures, the Exchange, or any other allegedly responsible party. The decision below has no effect on those rights.

Petitioner's assertion that a constructive trust should be imposed for her benefit on property in the Trustee's hands is without merit. In the first place, although Petitioner asserts (Petition at 5-6) that Weis failed to point out to her that her loan would be subordinated and failed to explain the subordination clause in her debenture, she admits the practical equivalent, namely, that she "... thought at the time of the investment that these debentures were really . . . shares of stock in Weis . . . ." (A73) (Petitioner's Affidavit). For nearly six years she received a high rate of return on her investment, which eventually went bad for reasons no one could foresee in 1967. Moreover, there is nothing to which a constructive trust could attach. Petitioner admits (Petition at 17) that her payments for the subordinated debentures became part of Weis' working capital. Accordingly, there is no fund of property to which Petitioner can trace her money. *See,* 4A *Collier on Bankruptcy* ¶ 70.25[2] at 354-56 (14th ed. 1978).[12]

[12] "Once the trust relationship has been established, one claiming as a *cestui que trust* thereunder must identify the trust fund or property in the bankrupt estate and, if such fund or property has been mingled with the general property of the bankrupt, sufficiently trace the trust property. In other words, to sustain a claim to trust property or to an equitable lien thereon, the claimant must depend upon his ability to identify the property in its original or substituted form in the hands of the bankruptcy trustee. The basic idea of the trust doctrine as applied in bankruptcy is a fair and reasonable identification of the property or fund so as not to harm other creditors. It is not enough, therefore, to show merely that the funds or property came into the bankrupt's hands or went into the bankrupt's business or, by the better view, even that the funds or property are contained somewhere in the bankrupt's estate." Footnotes omitted.



Petitioner's apparent assertion (Petition at 17-18) that because her money became part of Weis' capital nearly six years before this proceeding she is, as a matter of law, entitled to the imposition of a constructive trust on funds in the Trustee's possession, is simply to ignore the entire doctrine of the tracing of commingled funds.

## CONCLUSION

Respondent SIPC respectfully submits that the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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IN THE

# Supreme Court of the United States

October Term, 1978

**No. 78-746**

EVA GROSSMANN,

*Petitioner,*

vs.

EDWARD S. REDINGTON, Trustee, and SECURITIES INVESTOR PROTECTION CORPORATION,

*Respondents.*

**On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit**

## PETITIONER'S REPLY MEMORANDUM

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## PETITIONER'S REPLY MEMORANDUM

The briefs of respondents, the Securities Investor Protection Corporation (hereinafter SIPC) and Edward S. Redington (hereinafter Redington) are unresponsive to the questions presented by petitioner and, if anything, further demonstrate why those questions should be decided by this Court. Respondents seek to avoid rather than address the questions presented by attempting to equate petitioner's

claim with other claims that are neither pertinent to petitioner nor before this Court. Those inapposite claims arose out of transactions which are not only factually different from the transaction involving petitioner, but, more importantly, are claims based upon totally different legal principles and contentions. They involved attempts by subordinate lenders to rescind subordination agreements which, if they had not been fraudulently induced, would have been legal and proper. In contrast, petitioner, in legal contemplation, never occupied the status of a subordinate lender. Petitioner's affidavit, which for the purpose of the summary judgment entered in this case must be taken as true, states unequivocally that when she had turned over her entire life savings of $20,000 to the securities broker, nothing was ever mentioned to her of "subordinate debentures", and, if that term had been used, she would not have understood its significance. As far as $5,000 of the above mentioned sum was concerned, no debenture certificate was ever issued to her and nothing was said about any subordination agreement. Furthermore, petitioner never entered into any agreement with Weis Securities Inc., which somehow, in a manner never clarified in the record nor made known to petitioner, had supposedly acquired the business of Weis, Voisin, Cannon, Inc.

But even more important in the evaluation of this case is the blatant disregard with which respondents have treated, or rather failed to treat, the crass violation of the "suitability" or "know your customer" rule (NYSE Rule 405) which, under Section 6 of the Securities Exchange Act, NYSE was and is duty bound to enforce. NYSE approval is necessary to effectuate the sale of subordinate debentures. (See Redington brief, p. 3 footnote 3; SIPC brief, p. 8 footnote 9). By approving the alleged sale of $20,000 of subordinate debentures to a widow with a total



net worth of $30,000, NYSE became an active participant in the fraud perpetrated by the broker upon the widow, thus eradicating any legal basis for a valid subordination agreement. SIPC which, in turn, relies upon NYSE to enforce the securities regulations, componded the wrong by ignoring the violation of Rule 405 and assiduously fighting petitioner's claim. Thus, the securities regulatory system condoned and sanctioned the violation of its rules and acted in clear contravention of both its statutory duties and the purposes for which it was created.

There is absolutely no legal basis or merit to SIPC's attempt to justify the gross violation of the suitability rule (Rule 405) by the unsupported averment that "[t]he importance of the net capital rule far outweighs Petitioner's interest in enforcement of Exchange Rule 405 . . ." (SIPC brief, p. 10, footnote 11). Both of these rules are exchange rules of *equal force and validity* and neither is subordinate to the other; neither the legislature nor the exchanges have enacted the scale of priorities suggested by SIPC. They are not inconsistent with each other, but are both designed to protect investors and must be enforced in a manner where each operates in harmony with the other.

Respondents reliance on *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, 534 F. 2d 156 (9th Cir. 1976) is misplaced since that case is contrary to the position of respondents and the opinion of the lower courts. In *Hughes* the Ninth Circuit stated:

> Section 6 of the Securities Exchange Act imposes a duty upon registered exchanges to enforce the provisions of the Act and the rules promulgated pursuant to it. *To hold that registered exchanges have discretion as to whether those rules will be enforced would leave the exchanges in the societally unacceptable status of private clubs which existed before the passage of the Act. Id.* at 534 F. 2d 169 (emphasis added).

Not only have respondents failed to provide any justification for allowing SIPC to profit at the expense of innocent investors by arbitrarily deciding to enforce one rule and ignore and treat as nonexistent another rule of equal force and validity (see Petition pp. 15-16, and footnote 2 *infra*), but, more importantly, the aforementioned quotation demonstrates the conflict existing between the Second and Ninth Circuits which requires resolution by this Court. The recent amendments to SIPA[1] and the Bankruptcy Act do not detract one iota from the urgency of the resolution of this vital problem affecting the entire securities industry and thereby the national economy. The selective and arbitrary enforcement of statutorily mandated stock exchange rules and the granting of priorities of one rule over the other, not based upon legislative command, is a question which is likely to occur again and again, leading to uncertain and chaotic conditions in the securities market, hence harmful to the entire economy.

Petitioner is clearly the type of investor to whom Congress intended to accord customer protection. The determination of whether a person is a "customer" under SIPA is not to be made simply by a rigid literal reading of the Act, but rather by ascertaining whether that person is the type which Congress intended to protect with "customer" status. *Securities and Exchange Comm.* vs. *F. O. Baroff Co., Inc.*, 497 F. 2d 280 (2d Cir. 1974)[2]; *cf. Huges* vs. *Dempsey-Tegeler & Co., Inc.*, 534 F. 2d 156, 175 (9th Cir. 1976).

1. The amendment to SIPA is also inapplicable because it relates solely to rescission ". . . in a suit between a claimant and the debtor."

2. The same parties who successfully argued against a rigid literal construction of SIPA in *Baroff*, now, when it suits their purpose, argue that a rigid literal construction of SIPA is required.



As set forth in the petition (pp. 13-14), petitioner was clearly a "customer" under SIPA when she turned over to the brokerage firm her life savings with the belief that they would be properly invested. The question presented by petitioner is not whether a person may acquire "customer" status through rescission, but whether the illegal actions of a securities broker and the securities regulatory system's wrongful approval of a sale of securities which is plainly prohibited by an applicable securities regulation, divest an innocent investor of "customer" status. While this question is raised under the provisions of SIPA applicable to the instant case, it is not altered by the SIPA amendments of 1978 (Pub. L. 95-283) (See footnote 1 *supra*).

Furthermore, H.R. Rep. 95-746, 95th Cong. 1st Sess. 33-34 (1977) shows that, contrary to the decisions of the lower courts, Congress intended that anyone who had been fraudulently induced into a subordination agreement by a securities broker may rescind and participate in the liquidation as a general creditor, and not be relegated to the lowly legal status imposed upon petitioner by the lower courts. This report also discloses that Congress intended that if a transaction would deprive an investor of the protection of customer status, that fact must be made clear to the investor at the time of the transaction, *Id* at 34.

SIPA applies as if it constituted an amendment to the Securities Exchange Act and in *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 433, 12 L. Ed. 2d 423, 428 (1964), which involved the Exchange Act, this Court stated:

> [I]t is the duty of the Courts to be alert to provide such remedies as are necessary to make effective the congressional purpose.

In the present case the lower courts refused all of the remedies available to make effective the congressional pur-

pose of protecting investors in general and unsophisticated investors in particular.

SIPC's contention that petitioner may only utilize her common law and state remedies in a separate action contravenes this Court's holding in *Borak*. *Id.* at 377 U.S. 433-435. Moreover, SIPC's contention that there can be no constructive trust imposed because there is no fund of property to which petitioner can trace money, discreetly ignores the fact that under SIPA her money is sufficiently identifiable to be segregated and placed in the "single and separate fund" established by SIPA § 6(c)(B), which under the 1978 amendment is designated "Customer property" [§ 16(5)].

In light of respondents' inability to face the issues presented in the present petition without grossly distorting them and subverting the entire purpose of securities regulation, and because these issues far transcend the factual confines of the case at bar and affect directly the nation's economy, the need for plenary review of the decisions below is clear.

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